

IMMEDIATE CASH FROM SAFE INVESTMENTS

Whether your goal is to buy a house, finance a college education, or save for retirement, this book can show you how

- *Introduces the new investor to key terms and topics*
- *Offers proven strategies for investing as little as \$50 a month*
- *Provides options for immediate cash returns or long-term growth*

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To

Mary Rives and *Bob Black* as well as Other readers of my previous
books

Other Books by James F. Tucker

Essentials of Economics (1975, Prentice-Hall)

Current Economic Issues and Problems (1976, Houghton Mifflin)

Anatomy of High-Earning Minority Banks, 1971-1975
(1978, American Bankers Association)

Personal Money Management: A Guide to the Family's Financial
Affairs
(1985, Howard University Press)

Buying Treasury Securities at Federal Reserve Banks
(1987, Federal Reserve Bank of Richmond)

Managing Your Own Money: A Financial Guide for the Average Wage
Earner (1988, Dembner Books)

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Preface

Having experienced one of the most prolonged economic downturns during the early 1990's, and having been warned to brace for an indefinite economic future during the remainder of the 1990's, more Americans are searching for additional sources of income, as well as the kind of income that is less likely to fluctuate widely with changes in the economy. These people realize that holding a second job or having both spouses employed is not the answer. This leaves successful investing as the most appropriate and most reliable means for producing the additional money needed to offset the ever-rising expenses in most households.

Put in the simplest of language, this book is designed to help people to get additional money by utilizing the money that they already have. The discussion should aid persons interested in a basic knowledge of investing in financial instruments and is intended to provide guidance on how to invest in these instruments to satisfy the goals of the household.

Why should people buy this book when they can get similar information from financial columns in the newspapers? Two reasons come to mind immediately. One is that a column in a newspaper is necessarily restricted in the amount of space that it can devote to a particular topic, whereas, this book has no such limitation. Another is that a book is a more permanent source of reference than a newspaper column or a magazine article. Other advantages offered by this book include detailed explanations of every topic, timely illustrations, and definitions of key terms and concepts associated with investments.

While it is recognized that a vast array of investments are available to individuals today, the information and guidance offered by this book are limited to the more common financial instruments. There are perhaps instances in which an investment in precious metals or more sophisticated financial instruments may be more profitable. However, the purpose of this book is to serve those individuals whose income from investments may be crucial to their standard of living.

I am deeply grateful for all of the various experiences which

enabled me to develop the various topics discussed in this book. I am also grateful for the patience shown by my loving wife, Caroline, in typing and otherwise preparing this manuscript for publication.

James F. Tucker

Richmond, Virginia

CHAPTER 1

THE ROAD TO MORE CASH

Key Points Discussed

- . . . Who Should be investing
- . . . Sources of Savings
- . . . Putting Your Cash to Work
- . . . Doing Your Homework

CHAPTER 1

THE ROAD TO MORE CASH

... working a second job—

This deprives you of living a full and normal life, in that you are not able to do a lot of things that you want to do and should do. You will have little or no time for yourself or your family.

... getting a loan—

Remember, except for interest on your home mortgage, interest on loans are no longer tax deductible. Borrowing is okay for emergencies; otherwise, why pay a higher interest rate to use someone else's savings than the rate of interest that you are getting for the use of your savings.

... hitting the lottery—

This is more than a “hit or miss”; it's mostly a “miss.” Actually, you have two chances of getting more money from this source—very slim and none.

... receiving a donation of some sort; maybe a gift—

Don't hold your breath on this one. It'll never happen.

... robbing a bank—

Oh, no! This is definitely not the best answer. It's difficult to even describe all of the potential problems associated with this answer.

This leaves investing as your best bet for getting more cash immediately. According to *Webster's Ninth New Collegiate Dictionary*, the word ‘invest’ means “to commit (money) in order to earn a financial return.” In this book, we are defining ‘invest’ as simply, the act of buying a financial instrument for the purpose of earning a financial return. Many people often talk about the need to invest, but they frequently fail to do so while claiming that they know nothing about investing. Still others know something about investing, but not enough to have confidence in their investment decisions. Most of these people read the financial columns in the newspaper, and some even subscribe to magazines that specialize in providing information on investing. However, this group of people continues to procrastinate on investing beyond a passbook savings account, and they inevitably wind up saying either, “It's really too early for me to think seriously

about investing.” or “It’s too late for me to think about investing.” This, in turn raises the questions, “Who should invest,” and “How can a person invest with confidence?” Before any attempt is made to answer these questions, let’s review the following descriptions of five actual situations of three individuals and two families.

Young and Single

Neil Hamblin is single, 27 years old, and is an engineer with a large corporation. He has \$20,000 in a passbook savings account that earns 3.25% (as of 7/92). These funds are savings accumulated since his graduation from MIT five years ago. He plans to use these savings whenever he gets married. Currently, however, there are no prospects for marriage.

Young and Married

Kenneth and Tammy Tucker, ages 30 and 24 respectively, have found better jobs in another city. When they left their previous employers, they withdrew the vested funds in their retirement accounts. The total for both amounted to \$30,000. They planned to use these funds as a down payment on a new home, scheduled for completion in about seven months. In the meantime, they have deposited the \$30,000 in a local S&L in an account that allows checking and earns a rate which is 1% below the average T-bill rate for four weeks.

Middle Aged and Divorced

Jane Severance is 50 years old, gainfully employed as a professional, and saves an average of \$500 per month. She is a divorcee of six months, and has a home and a lump sum payment of \$50,000 from the divorce settlement. She plans to put the \$50,000 in a so-called money market passbook savings account.

Middle-Aged with Children

Henry and Agnes Porterfield are 50 years old and have twin sons in the ninth grade. Henry is employed as a high school principal, while Agnes works part-time as a receptionist at one of the local hospitals.

Recently, Agnes inherited \$60,000 from a favorite uncle, who indicated a desire for the money to be used to finance a college education for the twins. Agnes decided to deposit the money in a credit union savings account earning 6 percent.

Senior Citizens

Benjamin and Maude Cranston are retirees and together receive a pension of \$3,000 per month. They have a mortgage on their home. They have two adult sons, both of whom are married. One son has a lower-level civil service job, a non-working wife and five children. The other son draws workmen's compensation as a result of a job accident several years ago; has a wife employed as a licensed practical nurse; and has two school-age children. The elder Mr. and Mrs. Cranston frequently assist both sons with their living expenses, since they are able to save on an average of \$1,500 per month from their pension.

WHO SHOULD BE INVESTING

All five of the foregoing situations present cases in which the individual or the family should consider investing. In all five situations, the main principals have either a present or future need for an additional source of income, and are foregoing a major part of this additional income by failing to realize the need for investing.

Among the household groups who need a special reminder on the importance of investing are retirees and senior citizens. When asked about investing, these groups often respond with such statements as "It's too late for me to think about that; furthermore, I don't need any more money anyway. That's something for my kids to think about." Unfortunately, this statement fails to recognize several objectives that these particular groups should seek in planning for a comfortable, enjoyable, and useful existence during their remaining years. Retirees, for example, should be especially interested in investing, because while Social Security and employer pensions are important sources of income, earnings from investments can become the crucial difference between a comfortable retirement and one that forces severe restrictions in living in order to "make ends meet." Also, what about the likelihood of increased medical expenses that could occur for an extended period of time?

For most American households today, the question is not whether they will continue to live under a financial strain, but whether they can improve their financial and economic well-being by deploying their current resources in accordance with sound principles for investing. The major objective of this book is to provide guidelines on these sound principles of investing.

SOURCES OF SAVINGS

To invest, you must first have funds from some source. A few of us are fortunate enough to have a one-time source such as a lottery prize. Other one-time sources could include proceeds from the sale of

property, withdrawal of funds previously contributed to a pension plan, or proceeds from some type of financial settlement. For most of us, however, the source of funds for investing will come from periodic saving from our income, namely wages, salary, commission, and fees. Thus, for most of us, the starting point for investing is saving from our regular income.

In personal financial management, it is logical to think of your take-home pay as your production, and your actual spending as your consumption. When we subtract consumption from production, the remainder is savings. The ability to save is likely to be the key to your plans for investing.

You and your family should regard savings as one of the priority expenditures in the household budget. This decision to save should result from a clear understanding by the entire family of the reasons for saving. Such an understanding should make it easier to restrain spending by all members of the household. As the member of the household with training in personal money management, you should initiate and lead this discussion on treating savings like other household expenditures. This task may require more than a single discussion, and, in fact, the discussion is likely to take place each time a request is made for an optional or questionable expenditure.

Who should invest. . .	and why
young single workers. . .	to lay groundwork for second source of income
young marrieds. . .	to buy first home and set up the household
marrieds with children. . .	to finance increasing expenses from high school to college
the middle-aged. . .	to prepare for inevitable calls for assistance from grown children and aged parents.
retirees. . .	to cope with medical expenses that grow faster than pensions.

Experience indicates that every household can save. In other words there is no such thing, for example, as having too little income to save. The important thing is to have a savings plan and a strategy for saving. In setting up a savings plan, you should initially save to satisfy future needs, desires, obligations, and objectives. In other words, you should save for the reasons outlined as follows:

. . . **to cushion the financial impact of unexpected occurrences**, such as a death in the family, a sudden illness, an accident, or prolonged unemployment;

. . . **to meet large recurring expenses**, such as insurance premiums and taxes;

- . . . **to cover large nonrecurring expenses** which include home improvements and purchases of furniture and appliances;
- . . . **to fulfill short-term goals**, such as financing a vacation, buying an automobile, and purchasing gifts for Christmas, anniversaries, or birthdays;
- . . . **to fulfill long-term goals**, such as, purchasing a home, providing for a college education, paying for a wedding, buying a summer home or taking that “trip around the world”;
- . . . **to gain income** from the interest earned on savings;
- . . . **to accumulate funds**, which will be used for future investments.

As indicated above, one of the reasons for saving is to accumulate funds which will be used for future investments. This may well be the last reason because a sound financial plan for the household should assure that the other reasons are clearly satisfied by the plan before consideration is given to investing. A recommended path for channeling funds from your income, through savings, to investments is shown in Exhibit 1-1.

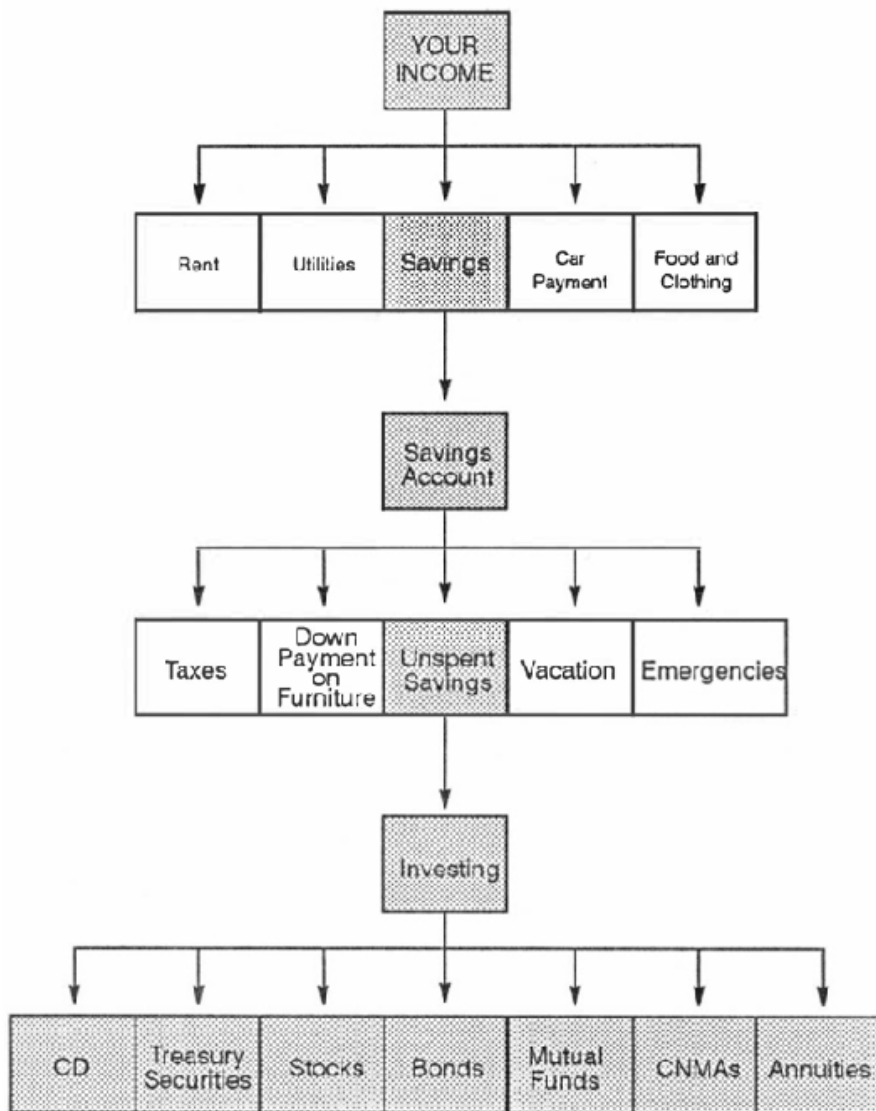
PRINCIPLES OF INVESTING

If we think of principles as a group of underlying rules of conduct, then the act of investing has a set of principles just as a number of other activities that people engage in every day, or frequently, or from time to time. This chapter provides an orientation on a core of principles associated with investing, although many other principles associated with specific investment instruments are discussed in subsequent chapters. As yet there is no formal theory of investing. The discussion in this chapter, however, makes every effort to present certain rules that have been identified with investing for many years, and to present them in an orderly fashion.

In any endeavor or activity, rules are needed for guidance and for the confidence of the people involved. Thus, another purpose of this chapter is to emphasize the importance of guidance in investing and to give you, the investor, the necessary confidence that you ought to have when investing your hard-earned money.

Exhibit 1-1

INCOME → SAVING → INVESTING



INVESTING VS. SPECULATING

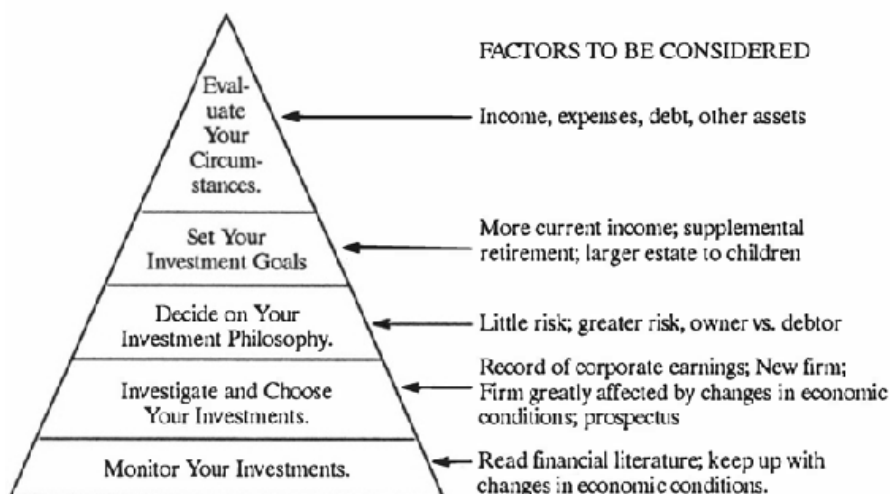
In the broadest sense, but in the simplest terms, investing means expending funds with a view toward making a profit. In defining the act of investing in this sense, it is useful to distinguish it from a similar act, namely speculating. While both of these acts usually involve the purchase of some type of asset, the reasons for the two acts are vastly different. Investing, as used here, means committing funds to a

productive venture with the anticipation of a profit from the success of the venture. More specifically, the venture involves the purchase of a financial asset in which the success will produce a profit in the form of dividends or interest. Speculating, on the other hand means expending funds or committing capital for the purchase of an asset in an attempt to make a profit from predicting short-term changes in the price of an asset.

As in most important acts taken by an individual, investing involves a sequence of steps that should be considered and then converted into decision-making by the individual. For example, the individual, or the investor in this case should first analyze his or her own circumstances in terms of such factors as income, cash requirements and ownership of other assets, before deciding on such factors as level of risk, the appropriate time horizon, and nature of investments. (See Figure 1-1)

Figure 1-1

5-POINT MODEL FOR INVESTING PROCESS



INVESTMENT GOALS

There are many reasons for investing, and different individuals have different reasons for investing. Such reasons may be referred to as goals, and before any attempt is made to invest, the investors should have their goals clearly established in their own minds, and if necessary on paper in one form or another. A written pledge of funds to a college, for example could constitute one form of setting forth a goal on paper.

As was said earlier, different individuals will have different

investment goals. Before setting these goals, however, each investor should review and analyze his or her own circumstances in terms of such factors as, income cash requirements, dependents, and projected net worth over the coming years, and then proceed to match these factors with a set of goals. Based on experience, some of the more common goals of investment are as follows:

- ...to supplement retirement income of
 - the current household and
 - the household of a surviving
- ...to make capital gains;
- ...to provide financial assistance to progeny;
- ...to provide for future gifts to favorite causes.

DIFFERENT STROKES FOR DIFFERENT FOLKS

Many investors are justified in having a combination of two or more investment goals. What changes over time is the emphasis they place on one or another goal at a given time in their lives. Also, investors justify different investment strategies for different stages in their lives.

After investors evaluate their own peculiar circumstances and establish a set of goals, they are in a position to review available investment alternatives in order to find the ideal match between their investment goals and investment instruments.

THE RISK FACTOR

Investing involves “risk,” which may be defined simply as “the chance of loss.” With this in mind, households should consider investing only at the point that the household can sustain a financial loss without lowering the standard of living of those in the household. Put another way, if the loss of invested funds will have a significant impact on income, then the funds should not be made available for investing.

Kinds of Risk

Defining or viewing risk simply as “the chance of a loss” may be viewing risk too simply. Many investors recognize a loss only when they invest a certain amount of money, and get less money back at the end of the investment period. Risk in investing, however can involve the chance of other kinds of losses. For example, when the investor buys any type of asset, whether it is a financial asset like stocks or bonds or a piece of real estate, there is always the chance that the market value of this asset will decline below the price that the

investor paid for it. As long as the investor retains this asset, it may be viewed as a “paper loss.” The price that people or business firms are willing to buy or sell an asset for is referred to as the market price, and since this price fluctuates, it is said that all investors are subject to “market risk.” Another kind of loss can result from inflation, which is defined as a persistent rise in prices. This development could mean that even if the investor receives more actual dollars from the investment than he or she paid out initially, the actual dollars returned could buy less in goods and services than the dollars invested. This is recognized as the loss of purchasing power, which means that all investors are subject to “purchasing power risk.”

The Price of High Risk

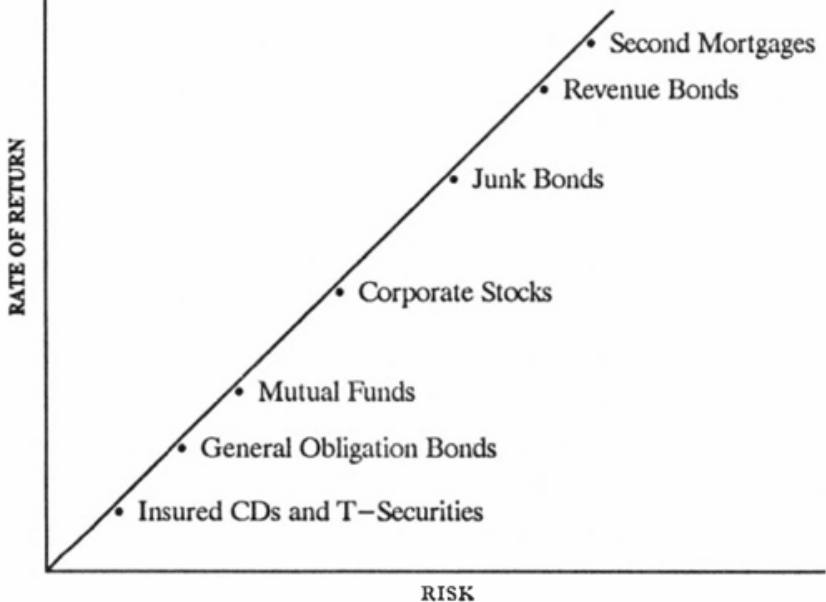
When a household invests money, it is natural to expect this money to earn more money. One word of caution, however, is that the household should avoid the temptation of quick and high profits on the money invested. Although high risk sometimes brings high profits, households with modest funds to invest should avoid these high risks and be content to earn the so-called **market rate of return** on the investment. (See Figure 1–2) When households with modest incomes forego buying some of the luxuries of life to accumulate savings, a loss of such savings through high-risk ventures can discourage future attempts to save, which in the long run could deprive the household of a higher standard of living.

Unavoidability of Risk

All investors should understand very clearly that they cannot avoid risk. This includes those investors who choose to do absolutely nothing with their funds because even if they decide to put the cash under their mattress they are subject to purchasing power risk in case prices increase. Thus, with risk as an unavoidable fact of the investor’s life, it behooves each investor to do whatever he or she can to minimize the risk when considering an investment. Risk itself exists because of uncertainty about the future. Thus, one way that the investor can reduce the risk is to learn as much as possible about the future.

market rate of return: average annual percentage return earned on investments such as Treasury securities, bank certificates of deposit, corporate securities, and securities issued by agencies of the federal government.

Rate of Return/Risk Relationship for Selected Financial Investments



Rate of return: earnings on asset, relative to cost of asset, expressed in percentage and annualized.

Risk: the uncertainty that the anticipated rate of return will be achieved.

PUTTING YOUR CASH TO WORK

If you are really serious about investing, then any time that you have cash on you or in a straight checking account at the bank or stashed some place in your house, you should think of yourself as losing money. Of course everybody needs to keep some cash available for those expenditures that require cash. Nevertheless, we should not forget that all money can be invested, and thus any money in excess of our petty cash needs is not producing additional income as it should.

One of the many theories in economics gives prominence to the so-called speculative motive for holding money. The reasoning behind this theory is that some individuals are likely to hold cash, thinking that interest rates will rise or that some other opportunity for financial gain will soon occur. Such a theory may or may not be true. However, even if yields on current investments are relatively low, you would still be foregoing additional income by holding the speculative resources in cash; and the longer you hold the cash waiting for a

profitable opportunity, the more money you lose.

Because you do lose money when you hold it and because there are times when you need to hold money or accumulate money to be prepared to make a profitable investment, you are obviously faced with several problems. How long should you hold the money? How much money should you hold? How accurately can you forecast an opportunity for a profitable investment? There are several possible solutions to these problems. For example, your speculative funds could be kept in a money market mutual fund where your money is available upon demand. This way, you would earn at least a modest amount of additional income on your money while you awaited that opportunity for a more profitable investment. Keeping abreast of financial developments and monitoring your household budget fairly closely should keep other problems to a minimum.

When we speak of having money in a money market mutual fund “where your money is available upon demand,” we are really speaking about having your money invested in “cash-equivalents.” Other investments regarded as cash-equivalents are bank CD’s, and short-term treasury bills. Cash-equivalents are assets in the investment portfolio, and they should be assigned a percentage allocation in the portfolio based on the objectives of the individual investor.

Asset-allocation itself can have a tremendous impact on investment returns. Indeed, several studies show that decisions about what percentage of the investment portfolio should be in stocks, corporate bonds, medium and long-term Treasury securities, savings bonds, tax-exempts and cash-equivalents, are more important in determining investment returns than decisions about which financial instrument to buy.

After you understand that investing entails some risk, that you can choose to be an owner or a creditor as an investor, and that the term of your investment can be crucial to future earnings, you are ready then to consider the characteristics of what you desire in an investment. In general, the characteristics of an investment should fit in with your financial goals and objectives. However, to assure that all of these factors are coordinated, you ought to recognize certain guidelines for judging the characteristics to of each investment and be prepared to compromise on these characteristics in order to achieve the **optimum value** from each investment. Experience indicates that the most useful characteristics to be considered when trying to achieve this optimum value are safety, **liquidity**, **rate of return**, **capital gain**, and tax liability.

DISPOSITION OF CASH		
Place	Purpose	%Earnings

Under your mattress	Supposedly safety	0
Checking account	To pay current obligations	3.25% or less (as of 7/92)
	and earn interest at the same time	
Savings account	Emergencies, future large-dollar obligations, etc.	5¼ maximum
Investments	Extra income	no limit

DOING YOUR HOMEWORK

A serious undertaking of investing involves both time and effort, but most of this can be spent right in the home. Such tasks as monitoring the household's cash flow, reading financial publications, checking the monthly balances on bank and credit card statements are likely to require some of your time every day. Reading a prospectus and trying to decipher a monthly print-out from your broker can be time consuming and challenging. However, all of these activities are home-centered, and notwithstanding the sacrifice in time, should prove to be valuable in your efforts become a successful investor, while helping you to attain the highest standard of living possible from your current financial resources.

optimum value: not the highest rate of return, but a respectable rate of return, in view of other desirable characteristics, such as safety, liquidity and minimum tax liability.

liquidity: the ease with which an asset can be converted into cash with little risk of loss of principal.

rate of return: annual percentage of profit on an investment.

capital gain: profit derived from the sale of an asset.

CHAPTER 2

TO WHOM TO LISTEN

Includes Vital Information On:

- . . . Free Information and Advice
- . . . Financial planners
- . . . Brokers as advisors
- . . . Advice available from accountants
- . . . The value of “inside information”
- . . . Advice from friends and others

CHAPTER 2

TO WHOM TO LISTEN

One of the most valuable tools, if not the most valuable tool, for investing is knowledge, and knowledge comes from information. Starting with the establishment of investment goals and continuing through the realization of these goals, the need to obtain, analyze, and otherwise use information related to investing is nothing short of imperative. While it is true that having this information does not guarantee success in investing, the failure to obtain this information leaves the chance for success entirely up to luck and often reduces the chances for success to almost zero. As discussed earlier, investing involves a decision-making skill needed for the investor to make the best decision when faced with several choices. By acquiring sufficient knowledge about investments through various sources of information, the investor can use this skill to its maximum potential.

Before attempting to use the information on investing and investments, you, the investor, should understand the key terms and concepts used in the discussion of these topics. This will help guide you through the reading on these topics, and also aid you in communicating with persons who may become involved in your investment affairs. For example, before you can make use of information on investments available at commercial banks, savings and loan associations, credit unions, and investment companies offering mutual funds, you ought to be acquainted with and understand such terms as **accrued interest**, **amortize** and **annual percentage rate (APR)**.

READILY AVAILABLE INFORMATION

Fortunately for investors, sources of information on investing are expanding, and many of them are not only readily available, but also relatively inexpensive. Most of us, for example, already subscribe to a daily newspaper and most of these newspapers carry stock market quotations, quotations on Treasury securities, and yields on mutual funds. In addition, newspapers in Richmond, Virginia, Washington, D. C., New York City, and other large metropolitan areas are noted for their informative columns on investing in the financial section. A

thorough and consistent reading of the financial section in many daily newspapers can provide you with timely information on such items as changes in tax rules, interest rates on CDs, as well as announcements of future offerings of stocks, bonds, and government securities.

If you read some of the information carefully enough to apply your analytical skills, you might be able to do your own forecasting of financial developments. For example, if you regularly buy treasury bills as a short-term investment, then you are aware that these securities are sold at **auction** every Monday at the regional Federal Reserve banks (and the Bureau of Public Debt in Washington, D. C.). The **yield** on the securities is not announced until after they are sold. In most instances you do not even know the direction that the yield will take—that is, up or down from the previous week. If you read the financial pages of your newspaper consistently, however, you might find information to help you to predict at least the direction of the yield on Treasury bills scheduled to be sold at the next auction. To illustrate further, whenever the Federal Reserve changes the **discount rate**, the announcement of the changes is usually the subject of an article in every local newspaper the next day (See Exhibit 2–1). On the Monday following the story, Treasury bills are offered at auction to the public. If the announced change in the discount rate is an increase, more than likely the rate on the Treasury bills will increase. If the change is a decrease, usually the rate on the Treasury bills will decrease.

To illustrate this, in the Treasury Auction on the Monday following the decrease in the discount rate shown in Exhibit 2–1, rates on Treasury bills decreased as follows:

Rates on Treasury Bills

Dates	3–Month %	6–Month %
August 18, 1986	5.65	5.65
August 25, 1986	5.32	5.35

accrued interest: interest earnings accumulated on a financial interest-bearing asset.

amortize: to reduce a debt through regular and equal payments.

annual percentage rate (APR): the cost of credit over a full year, expressed as a percentage, reflecting all costs of the loan as required by the Truth in Lending Act.

auction: the sale of Treasury securities by the U. S. Treasury on a bid basis.

yield (or rate of return): measurement of the profitability of an investment; it is usually per year on the amount invested; often referred to as return on investment.

discount rate: the rate of interest that Federal Reserve Banks charge financial depository institutions that wish to borrow funds from these Banks

As you can see from the above illustration, the rates on both 3-month and 6-month Treasury bills showed a decrease at the Monday auction of August 25, following the decrease in the discount rate announced on the previous Thursday, August 21.

Literature

A number of magazines, such as, *Business Week*, *Time*, *Newsweek*, *U.S. News and World Report*, and *Black Enterprise* devote specific sections to information on investing. In addition there are magazines that specialize in information on investing and matters related to investing. The best known of these are *Money Magazine*, *Changing Times*, *Consumer Reports*, *Money*, and *Your Moneysworth*.

Of course, there are a number of books published on investing, including the one that you are presently reading. These books may be found in public libraries, college libraries, and in local bookstores. As sources of information on investing, books enjoy a number of advantages over newspapers and magazines. For example, books are .

. .

- . . . more permanent in physical structure;
- . . . stored more easily, thus lending themselves to future referencing;
- . . . capable of bringing together in one place a wide variety of topics on investing.

FINANCIAL PLANNERS

One of the more notable cases of fraud in financial planning was reported in a financial column in the *Wall Street Journal*. The columnist described how 50 Florida Doctors allegedly lost \$25 million to a financial planner in the Miami area. After collecting the money, this particular financial planner fled the country, leaving each of the doctors with only a handwritten note addressed to “Dear Client” and saying “By the time you have received this I will be gone. I have run away.”¹

Exhibit 2-1

Fed drops discount rate to 5.5%

Board's attempt to stir economy may not be last this year

By Martin Crutsinger
The Associate Press

WASHINGTON—The Federal Reserve Board is trying once again to stimulate a sluggish economy by slashing a key bank lending rate, and many financial analysts are predicting it won't be the last effort this year.

The Fed announced that effective today it is cutting its discount rate, the fee it charges for loans to U.S. banks, from 8 percent to 5.5 percent, the lowest it has been since August 1977.

Economists predicted the Fed action would be followed immediately by a cut in the prime lending rate charged by banks. They said other business and consumer interest rates, including mortgage rates, would fall as well.

Analysts predicted that in addition to the prime rate falling to 7.5 percent, mortgage rates would dip below 10 percent, down almost 4 percentage points from the highs of last year.

Several interest rates already have fallen to the lowest levels in nine years, and the Fed action is expected to accelerate that trend.

The Fed hopes the lower interest rates will stimulate consumer and business spending and provide the momentum to get the stalled U.S. economy moving again.

The Central bank announced its decision yesterday, a day after the government revealed that the overall economy, as measured by the gross national product, slumped to an annual

growth rate of 0.6 percent, the weakest showing since the end of the last recession.

The GNP figure and other economic signals have raised new fears that the 44-month-old economic recovery is in danger of toppling into another recession.

The Fed action marked the fourth time this year that the central bank has cut its discount rate after disappointing news about the economy's performance. Analysts predict a fifth reduction could come in September if the economy remains in the doldrums.

"The Fed is in a month-to-month watch focusing on the domestic economy," said David Jones, an economist with Aubrey G. Lanston & Co., a government securities dealer.

"As long as the economy remains flat, the Fed is prepared to push interest rates lower."

Both Jones and Allen Sinai, chief economist for Shearson Lehman Brothers, said the Fed also was interested in cutting the discount rate as a way of driving down the value of the dollar on foreign exchange markets and thus shrinking the country's disastrous foreign trade deficit.

By pushing interest rates in the United States lower, the Fed drives down the value of the dollar because foreign investors are less enthusiastic about holding U.S. investments that earn lower rates. A weaker dollar, in theory, drives up the costs of imports to Americans

while lowering the price of American agricultural products and other goods on overseas markets.

The trade deficit, expected to soar to a record \$170 billion this year, is blamed for the near recession in American manufacturing and farming and the disappointing growth of the past two years.

In recent days, top administration officials, including White House budget director James Miller and chief of staff Donald Regan, joined the chorus calling for Fed Chairman Paul Volcker to cut the discount rate. Many Republicans feared that a worsening economic picture would prove disastrous to GOP election chances in the fall.

The last time the Fed reduced the discount rate this many times in a year was in 1982, when it cut the rate seven times as part of a strategy to drive interest rates down and get the country out of a deep recession.

Yesterday's decision came on a unanimous vote of all seven members of the board. The other reductions were made July 10, April 18 and March 7.

The March cut came only after four Reagan appointees to the board outvoted Volcker in February. Volcker, who never before had lost a board vote, prevailed on his colleagues to wait until he could convince the West Germans and the Japanese to join in a coordinated effort to reduce interest rates.

Source: *Richmond News Leader*, Thursday, August 21, 1986.

Although at least 12 states have laws aimed at curbing fraud and abuse by financial planners, the major federal law affecting financial planners does not really regulate them. The law does little more than require all investment advisors to register with the U. S. Securities and Exchange Commission (SEC) and provide details on their educational

backgrounds.

PLANNERS MUST REGISTER IN VIRGINIA

In Virginia, financial planners who do business in the state and charge a fee, must register with the State Corporation Commission. They are required to provide information on their educational background experience and any lawsuits, criminal action or disciplinary measures that have been taken against them or are pending against them. Moreover, the commission will investigate complaints against financial planners.

Basically, a financial planner is a professional financial advisor who attempts to assist people in establishing and achieving their financial goals. In her study, *Financial Planning Abuse: A Growing Problem*, Barbara Power, estimated that “between 250,000 and 400,000 people across the country call themselves financial planners,”² however, only about 10,000 of these are registered with the SEC. The titles and credentials of some of the financial planners are shown in Exhibit 2-2.

Exhibit 2-2

ADVISORS: THEIR INITIALS AND CREDENTIALS



CFB.

This is a *Certified Financial Planner*. This is perhaps the best known of the financial advisers. The title is conferred by the International Board of Standards and Practices. The title may also be conferred by any institution of higher education that meets the Board’s criteria. The course usually takes two years complete.



ChFC.

This is a *Chartered Financial Consultant*. Most of the individuals start out in the insurance business. To qualify as a ChFC, the individual must take a correspondence program, with a core of six courses and four electives. It takes an average of four years to complete the program and the candidate must pass ten two-hour examinations.



OMSF.

This denotes the degree, *Master of Science in Financial Services*, offered as a graduate degree by certain institutions of higher education.



ORFP.

This is a *Registered Financial Planner*, a title bestowed by the International Association of Registered Financial Planners. The requirements are: three

years of full-time experience as a financial planner; a CFP, ChFC, CPA (certified public accountant) or degree in law or business; and a license to deal in securities.

If you really feel the need for a financial planner, you might start by asking your banker to recommend one. Most financial planners will meet with you initially free of charge, but before agreeing on an interview, be sure to inquire whether a fee is involved. If your banker is not familiar with the planner's credentials, it would not be out of order for you to inquire about the planner's licenses and professional designations.

There are at least two categories of financial planners who charge fees. One category accepts clients with relatively high minimum amounts to invest or total investments in their current portfolio. As an advantage, these planners will cite the fact that they do not have products of their own to promote, such as, stocks, bonds, or insurance. They claim that their time is spent fully in researching investment products in order to give clients the best advice possible. Another group of planners charges a fee for drawing up a financial plan for a client, and then takes a commission on the sale of an investment product that he sells to the client.

One category of financial planners sort of falls in between these first two categories, in that they charge no fee but accept a commission on the investment products that they sell. Among the financial planners in this group are stock brokers and insurance salesmen.

Whether you engage the fee-financial planner or the non fee-financial planner, you would be well-advised to have some idea about your financial goals, objectives, time, etc. You know more about your personal circumstances than anyone else, so you should not permit any so-called expert to make all of the important and final decisions on your investments. You should listen to the advice of your financial planner, but you should also ask questions relative to this advice, and by all means, do not invest in anything that you do not fully understand.

BROKERS

If you are interested in buying stocks or other types of financial investments, a broker can provide you with very valuable information and advice. Generally, brokers must adhere to "just and equitable principles of trade." One of the most important of these is the principle of "suitability," which relates to the question of how

appropriate a specific investment is for a particular investor.

The suitability standard is found, in one form or another, in the rules of the Securities and Exchange Commission (SEC) and of most of the securities industry self-regulatory organizations, the national securities exchanges, and the National Association of Securities Dealers. For example, the rule applicable to brokers regulated directly by the SEC provides that a broker must have reasonable grounds to believe that his or her recommendations to a customer are not unsuitable for that customer, based on information concerning investment objectives, financial situation, or particular needs of the investor.

Notwithstanding the aforementioned SEC rules, it is important to note that these rules do not cover bad advice or poor market decisions that brokers make from time to time. For example, if we go back in time to “Black Monday” on October 19, 1987, when the Dow-Jones Industrial Average fell over 500 points, we find a great deal of criticism of brokers’ advice. A prominent source of criticism was the state securities regulators who charged that many of the losses to investors during this stockmarket plunge resulted from shoddy brokerage practices and irresponsible investment advice, and not falling stock prices.³ Further criticism came from James C. Meyer, President of the North American Securities Administrators Association in testimony before a congressional subcommittee. Mr. Meyer claimed that “half of the problems reported by investors in the wake of the stock market crash were not caused by events of October 19.” He went on to say that brokers placed unsophisticated investors in high-risk investments, conducted unauthorized trading in investors’ accounts, provided inadequate disclosures to clients about the riskiness of certain trading strategies, and used “false and misleading information in their sales practices.” He indicated that his testimony came from an analysis of more than 2,500 complaints received by his Washington-based association from a telephone line between November 9 and December 4. From November 9 to December 16, he stated that his association received more than 8,000 telephone calls from small or moderate investors. In studying the calls, the association calculated that callers lost almost \$500 million, or an average of \$172,000 per caller during the market plunge.⁴

As expected, there were challenges to these complaints from the various stock exchanges and the National Association of Securities Dealers. Among other things, they claimed that the Securities Administrators Association “jumped to conclusions,” and that the latter group “appeared to be relying on a series of hot line or telephone complaints in conjunction with the most tumultuous market experience of the decade.”⁵

All this boils down to a conclusion that the investors should be very careful when considering the advice of a broker. In some instances, a broker's advice on investing may be colored by the desire to secure commissions. Thus, if the investor suspects this motive, he or she should cross-check this advice with other sources of information and advice. Further, if the broker's advice turns out to be consistently faulty, then the investor should find a new broker.

ACCOUNTANTS

For many years, accounting firms have been providing investment advice to corporate executives and other high-income individuals as a part of their expertise in financial planning. In the case of executives, the fee for this service was paid for by the corporation as one of the many fringe benefits offered to such executives. Recently, however, many lower-level managers and staff persons have demanded and received this same benefit, giving accounting firms reason to believe that their services can be successfully marketed to all investors.

At one time, accountants were better equipped to tell investors "where they had been, and not where they ought to be going." However, things have changed. Many of the larger accounting firms have staffed themselves to give investing advice by buying the entire practice of financial planners, particularly the "one-person practices." Other firms have encouraged CPA's already on their staff to complete requirements for designation as an Accredited Personal Financial Specialist. To qualify for such a designation, a CPA has to have practice experience in financial planning, pass a one-day financial planning test, be a member of the American Institute of Certified Public Accountants, and meet continuing reaccréditation requirements, including professional education and experience. This development has enabled accounting firms to provide investors with an expanded package of investing advice and information, and to include the annual service of income tax preparation which many investors have been buying anyway.

Most CPA's who are financial planners hesitate to venture further than advice. They are rarely willing to make recommendations on investments, insurance, and estate planning. They do help clients to establish financial goals, and then to proceed to develop a financial plan. Often they will assist a client in choosing an investment advisor and then help to monitor the advisor. One factor that favors the CPA as a financial planner is that he is not in the business of selling an investment product.

INSIDE INFORMATION

All investors are familiar with the term, “hot tips.” However, few investors are in a position to distinguish between “hot tips” and so-called inside information. By definition, inside information is not available to the general public, and the use of such information for personal gain by employees of the firm in question, by brokers or investment managers is illegal. This does not mean that an investor must ignore casual discussions of business activities and operations by persons who are unaffiliated with the firms being discussed. After the investor hears such information more than once, he or she would be logical in thinking that such information may be of great value in guiding their investments in a particular firm. Knowledge of so-called inside information before it is made public could increase the investor’s ability to make profitable investment decisions.

PROSPECTUS

Like a newspaper, magazine, and a book, a prospectus is a generic-type source of information for investors. A prospectus associated with a specific type of investment will be discussed in subsequent chapters.

In essence, a prospectus is an “offering circular” required by the Securities Act of 1933 whenever securities are being offered to finance a corporation. The document purports to provide information intended to assist potential investors in evaluating the merits of the securities being issued to finance the corporation, and to inform these investors that the securities are being registered with the Securities and Exchange Commission (SEC). The SEC does not approve the issue of stocks as to their worth, but rather that all information required by the agency has been provided and that the document is complete in format and content. The prospectus contains detailed financial and legal information about the issuing corporation and the proposed security offering.

FRIENDS AND OTHERS

As you can imagine, there are all sorts of advice on investing, and there are innumerable sources for this advice. Most of the sources cited so far may be viewed as professional because they either have extensive experience in investing or, in addition to such experience, they have formal training in investing. While all of these sources deserve respect, investors should not ignore the nonprofessional sources. These sources would include friends and acquaintances who have experienced investing; who monitor the financial sections of the newspapers; who subscribe to the specialty magazines; and who remain alert to all financial discussions and all news on investing.

As with all other sources, investors should scrutinize information and advice on investing from their nonprofessional friends very carefully. On the one hand, such information and advice can be invaluable. On the other hand, it can be disastrous. For example, one area where the information can be invaluable is the friend's experience with a particular broker. This does not mean that you could necessarily favor recommendations on only those brokers who have recommended a few profitable investments for your friends. It means that you would appreciate information on a broker's character, honest judgments, sincerity, and general reputation.

Today's investors must make a number of crucial decisions on their way to an investment program that satisfies their investment goals. The best decisions will be tied to the investors' knowledge, and this knowledge will come from information and advice on investing. All of this places a very important responsibility on investors because in the final analysis, their financial and economic welfare will be affected most. The amount of information and advice available to investors is staggering and continually growing. Thus, investors should become efficient in searching out information and advice, scrutinizing it carefully after it becomes available, and then using it in a way that will maximize their financial welfare and enable them to enjoy a successful career in investing.

Footnotes

¹ Earl C. Gottschalk, “Your Money Matters”, *The Wall Street Journal*, November 16, 1988, p. C-1.

² *Washington Post*, July 16, 1987, p. E-3.

³ *Richmond Times Dispatch*, December 17, 1987, p. 18.

⁴ *Ibid.*

⁵ *Ibid.*

CHAPTER 3

EASY MONEY FOR BEGINNERS

Explains fully:

- ... CDs
- ... Variable rates
- ... Compounding interest on CDs
- ... Savings bonds

CHAPTER 3

EASY MONEY FOR BEGINNERS

While many individuals recognize the need for investing, are ready for investing, and are willing to get involved with investing, they are very much concerned with the safety of their investments, the paperwork associated with investing, and any fees charged in connection with investing. In other words, many potential investors want: (1) an investment in which the return of principal and the income earnings are guaranteed; (2) the forms to be executed and the reading of documents are minimal; (3) and no money to be expended for anything other than the price of the investment itself. Frankly, this is not a very tall order to fill, if the investor is willing to compromise on some of the other characteristics of an investment such as rate of return and potential for a capital gain.

SOURCES OF MONEY RECEIVED FROM INVESTMENTS

Remember, the money that you will receive as a result of your investing can come from only three sources:

1. The interest you receive for lending your money to others.
2. The dividends you receive from buying ownership in a corporation; and
3. The gain in the value of an original investment when you sell that investment.

CERTIFICATES OF DEPOSIT

A certificate of deposit or time certificate of deposit (CD) is a certificate issued by a financial institution as evidence that a certain amount of money is on deposit for a fixed period of time and will be redeemed at the end of this fixed period of time. As individual investors, you would be interested in the consumer-type of CD, issued by commercial banks, savings banks, savings and loan associations, and credit unions where the amount of the CDs are insured up to \$100,000 by an agency of the federal government. This kind of CD is non-negotiable, meaning that owners cannot readily transfer their rights to the instrument before it matures.

As an investment, CDs meet all of the requisites mentioned in the first part of this discussion. The only paperwork involved amounts to providing the necessary information on name, address, social security number, type of ownership, and period for receiving interest earnings; there are no fees for a middleman or cost of processing the paperwork; and the principal of the investment is insured up to \$100,000.

As a result of the fierce competition between financial depository institutions, an investor can get a CD that is practically tailor-made to fit his or her peculiar circumstances and financial objectives. For example, today you can find CDs with no early withdrawal penalty after the first seven days; CDs with variable rates of return; CDs that the investor can choose the maturity date; and CDs that are “time open” accounts to which the investor can make additional deposits during the term of the CD.

In addition to the aforementioned characteristics of a CD, some investors may lean toward this instrument as an investment because it assures the investor of a steady and stable stream of earnings. If the yield on a CD at the institution where your checking account is located is competitive, you can maximize your interest earnings by requesting those earnings to be deposited automatically in your checking account. This enables the interest earnings to earn more interest immediately. On the other hand, if you request the interest earnings on the CD to be paid to you by check, waiting for it to arrive in the mail, taking it to the bank and waiting for the check to clear could result in a period of several days on which the money does not earn interest.

Also, if an emergency for the investor does arise, the loss from the liquidation of a CD is limited and can be calculated in advance.

“NAME YOUR MATURITY CD”

If you know precisely when you will be needing your funds for a specific purpose, you can buy a CD that matures on or close to that date. Some depository institutions will allow you to pick any maturity “from 32 days on out.” If you think that you might need your money but don’t know when, the you should consider a no-penalty CD.

While CDs do enjoy a number of advantages over other investments, an investor concerned about the requisites mentioned earlier should still be alert to other factors associated with CDs. Some CDs, for example, have minimum investments of \$100 or \$500. Many others, however, have minimums ranging from \$5,000 to \$20,000. This latter group usually offers: (1) no withdrawal penalty; (2) the privilege of drawing checks; and (3) the opportunity to add to the

principal in certain increments. There is also the question of interest rates or rate of return. A certain fixed rate for a CD with a 5-year maturity might look very good now, and would look even better if market rates start to decline. On the other hand, how would it look if rates increase? If we pursue these questions a bit further, we can see that a variable rate CD can provide you with a hedge against the risk of a change in market rates, and some of these actually allow the investor to lock-in on a minimum rate. However, the investor should be clear about the other characteristics of such CDs because many of them have extraordinary long maturities. Finally, the investor should make sure that the CD is actually offered by the bank, S&L, or credit union where each individual depositor is insured up to \$100,000 by an agency of the federal government, and not by another organization located on the premises on one of these depository institutions. When a CD is insured by an agency of the federal government, the logo of the agency, i.e. FDIC, usually appears somewhere on the CD itself.

LIMIT ON FDIC COVERAGE

Remember! The federal insurance for deposits in a depository institution with FDIC coverage is limited to an aggregate of \$100,000 for individuals and organizations, not \$100,000 for each deposit account. For example, if you have \$150,000 in a CD and \$50,000 in a checking account at the same bank, and that bank fails, your insurance coverage is limited to a total of \$100,000.

In addition to the aforementioned information on CDs, investors should have a clear understanding of some of the other factors related to this particular investment instrument.

Simple Interest and Compounding. The simple interest rate on deposits can be compounded. That is, interest can be earned on accumulated interest as well as on the amount initially deposited. Compounding can occur over different time periods, such as continuously, daily, monthly, quarterly, semiannually, and annually. The more frequent the compounding, the higher the effective yield or total earnings on the account.

Interest Rates and Annual Yields. When shopping for CDs, investors should compare the interest rates and effective annual yields stated by various institutions.

Variable Rates. If the depository institution pays a variable rate on CDs, this rate will usually be tied to an index that is beyond the institution's control, such as a Treasury security rate. The variable rate will float with fluctuations in the index.

Early Withdrawal Penalties on Time Deposits. If the depository institution agrees to redeem a CD prior to maturity, Federal

regulations specify a minimum penalty which must be imposed. The applicable penalty varies depending on when the account was opened as well as on the institution's own policy.

A depository institution is required to disclose the penalty it will impose for early withdrawal, which may be more severe than the minimum required penalty. Generally, the institution has the option of refusing to allow the early withdrawal altogether.

TREASURY SECURITIES PURCHASED DIRECTLY FROM FEDERAL RESERVE BANKS

One of the victims in the aforementioned *Wall Street Journal* article was a physician who lost \$500,000 in the fraudulent activities of the so-called investment adviser. This physician was quoted as saying that this convicted investment adviser, "not only stole from me. He stole from my heirs."¹ How right he was! Just think, had this physician purchased \$500,000 worth of U. S. Treasury (Treasury) 30-year bonds at 9 percent, he and his heirs would have had \$45,000 in interest earnings every year for the next thirty years, and the investment could have been made with the criteria set forth for the "simplest investments" at the beginning of this discussion.

When you invest in Treasury securities by buying them directly from Federal Reserve Banks, you have an investment on which the principal and income earnings are guaranteed by the U. S. Government; there are only five lines to be completed on a one-page form to execute the purchase; and there are absolutely no fees to be paid in connection with making the transaction. Banks, on the other hand, often charge customers between \$35 and \$60 to buy Treasury securities. All of the details in investing in Treasury securities are discussed in Chapter 8.

Buying U.S. Treasury Bills, Notes and Bonds

New Treasury securities can be purchased directly from the Federal Reserve through the Treasury Direct System, or through banks and brokerage houses. Many investors find it easier to invest in them through brokers or mutual funds.

Type	Maturity	Minimum Purchase	Issued
Treasury Bills	3, 6 and 12 months	\$10,000 (sold in multiples of \$5,000 (above minimum)	3- and 6-month bills issued weekly, usually on Monday; one-year sold monthly
Treasury Notes	2-3years	\$5,000 (sold in multiples of \$5,000)	21 year notes issued monthly; longer-term sold quarterly

	4-10 years	\$1,000 (sold in	
		multiples of	
		\$1,000)	
Treasury Bonds	Over 10 years	\$1,000 (sold in	Quarterly
		multiples of	
		\$1,000)	
Source: Federal Reserve Bank of New York			

In addition to qualifying as one of the simplest investments available, Treasury securities have a number of other advantages. For example, the interest earnings on these securities are exempt from state and local income taxes. Also, they may be purchased by mail from a Federal Reserve Bank by investors who do not live in cities where such banks are located.

SAVINGS BONDS

Like CDs and Treasury securities, United States Savings Bonds meet the requisites of many potential investors because these Bonds: (1) guarantee the return of principal and interest earnings; (2) involve a minimum of forms to be executed and documents to be read; and (3) exact no fees from the investor for making or processing the investment. Perhaps this is why more Americans own Savings Bonds than any other single investment.

Where to Buy and the Safety Factor

Series EE Savings Bonds may be bought over-the-counter or by mail at banks, savings and loan associations, and other financial institutions qualified as issuing agents or from Federal Reserve Banks and Branches, and the Bureau of Public Debt, Washington, DC 20226. These Bonds may also be purchased on a regular basis through the Payroll Savings Plan offered by many employers or the Bond-A-Month Plan offered by many banks.

If bonds are lost, stolen, damaged or destroyed, you should notify the Bureau of the Public Debt, 200 Third Street, Parkersburg, WV 26106-1328. If possible, you should include serial numbers, issue dates, names and addresses which were on the lost Bonds as well as your social security or employer identification number.

Price and Purchases

The price you pay for Savings Bonds is half the Bond's face value. Savings Bonds are available in eight denominations, from \$50 to \$10,000.

Denomination	Purchase Price (half face value)
--------------	----------------------------------

\$	50	\$	25*
	75		37.50*
	100		50
	200		100
	500		250
	1,000		500
	5,000		2,500
	10,000		5,000

*Sold over the counter only.

The limitation on the purchase of EE Savings Bonds is \$30,000 face amount (15,000 issue price). This limit governs the amount of bonds which may be purchased in the name of any one person in any one calendar year. In computing the limit, Bonds registered in co-ownership form may be applied to the holdings of either co-owner, or apportioned between them, up to a maximum of \$60,000 face amount (\$30,000 issue price). For purposes of the limit, Bonds registered in beneficiary form are applied wholly to the owner's holdings. No limit applies to HH Bonds received in exchange for E Bonds/EE Bonds/Savings Notes, or through the authorized reinvestment of the redemption proceeds of matured Series H Bonds.

Interest Earnings and Rates

The difference between the price paid for EE Savings Bonds and the redemption value is interest. Interest is collected at redemption. Bonds are guaranteed for at least 18 years from issue date, *at guarantee of 4 percent*. In other words, the owners of EE Savings Bonds will double their money, at the current guaranteed minimum rate of 4 percent, if they hold the Bonds for 18 years. If rates paid are higher than 4 percent, the maturity will remain the same and a Bond will be worth more than the face value at maturity. *This means that the owner will receive the benefit of all rates higher than 4 percent.*

Beginning with EE Bonds issued March 1, 1993, the minimum rate for Bonds held five years or longer is 4 percent. Older Bonds will retain their previously guaranteed minimums until the end of their original maturity periods or current extended maturity periods. These Bonds assume the minimum rate in effect for new issues when they enter their next extension period.

When held for at least five years, Series EE U. S. Savings Bonds earn market-based interest or a guaranteed minimum of 4 percent, whichever is higher. The market-based rate, announced each May 1st and November 1st is 85 percent of the market average on five-year Treasury securities. These Bonds pay interest by increasing in value. Their value at their maturity will be at least the face amount and more if the market-based rate is higher than the guaranteed minimum.

The market-based rates are averaged and applied to the Bond, rounded to the nearest quarter percent and compounded semiannually to determine its yield and redemption value.

Bonds issued before November 1982 will accrue market-based interest beginning with the first interest date on or after November 1, 1987. Bonds more than 40 years old no longer earn interest and should be redeemed.

Redemption

New issues of Series EE bonds held less than five years will earn interest at a fixed rate of 4 percent (the minimum rate required by law). Because of the statutory floor of 4 percent, the redemption values of new series EE bonds will increase each month, rather than semiannually. The redemption values on Series EE Bonds issued before March 1, 1993, however, will continue to increase semiannually.

Series HH Bonds may be redeemed at any Federal Reserve Bank or Branch, or at the Bureau of the Public Debt, six months from date of Issue.

Exchange for Series HH Bonds

Series HH bonds may be purchased in exchange for outstanding Series EE and E bonds and Savings Notes (Freedom Shares). EE Bonds are eligible for exchange six months after issue; E Bonds remain eligible for exchange for one year after final maturity. Bonds/Notes submitted in exchange must have a combined current redemption value of \$500 or more. Owners who have deferred reporting, for Federal tax purposes, the interest as it accrued on the securities exchanged, may continue to defer such reporting to the taxable year in which the HH Bonds received in exchange are redeemed, disposed of, or reach final maturity, whichever comes first. See Department of Treasury Circular, Public Debt Series No. 2-80, for rules governing this exchange offering.

Series H Bonds cannot be exchanged for Series HH Bonds, and should be redeemed as they reach final maturity. At the owner's request, the Treasury will reinvest the proceeds of the sale of matured H Bonds in Series HH Bonds. Reinvestment does not provide for the continuation of any tax deferral, nor is it subject to an annual limit.

Series HH Bonds are issued only at Federal Reserve Banks and Branches and the Bureau of the Public Debt. Banks and other financial institutions will accept and forward exchange applications and the Bonds being exchanged to the nearest Federal Reserve Bank or Branch. Delivery of Bonds will be made by mail in accordance with the purchaser's instructions. Series HH denominations at face amount

are: \$500, \$5,000, and \$10,000.

Registration

Series EE and HH Bonds can be registered in three ways:

- Single ownership form in the name of one person;
- Co-Ownership form, with two persons as co-owners; and
- Beneficiary form, with one person as owner and another as beneficiary.

No more than two people can be named on any one Bond.

However, many employers allow multiple allotments for Bonds with differing inscriptions. In all cases, owners or first-named co-owners must provide their social security numbers for inscription onto the Bonds.

If Bonds are registered in co-ownership form, either co-owner may cash the Bonds. For authorized reissue of a co-ownership Bond, both must join in the request. If registered in beneficiary form, during owner's lifetime only the owner may cash the Bond. For authorized reissue of the beneficiary Bond, only the owner must sign request.

Tax Status

Series EE: The difference between the price paid for EE Bonds and the redemption value is interest. It is subject to Federal income tax, but not to state or local income taxes. Interest is reportable as it accrues for Federal income tax purposes, but such reporting may be deferred until the Bonds are cashed, disposed of, or reach maturity, whichever comes first.

A notable exception to the Federal Income tax on interest earnings from Series EE Savings Bonds is contained in the Technical and Miscellaneous Revenue Act of 1988. The interest on Series EE Savings Bonds issued after December 31, 1989 may be exempt from Federal income tax if you have certain educational expenses during the year the bond is redeemed. Such expenses would include tuition and fees for you or your children at colleges, universities and qualified technical schools. There are a number of income and other restrictions on the use of this benefit. For more information on this educational benefit write to: Office of Public Affairs, U. S. Savings Bond Division, Washington, D. C. 20226.

Series HH: Interest is subject to Federal income tax, but not to state or local income taxes. Such interest must be reported for the year in which interest is paid.

Both Series: Bonds are subject to other taxes, such as estate, inheritance and gift taxes—whether Federal or state—but they are exempt from all other taxation imposed on principal or interest by an

state, U. S. possession, or local taxing authority. Complete information regarding the tax status of Series EE and HI-I Bonds is found in Department of the Treasury Circulars, Public Debt Series No. 1–80 (Series EE) and No. 2–80 (Series HH), latest revisions. These are available from Federal Reserve Banks and Branches.

RESTRICTIONS ON THE ELIGIBILITY OF SERIES EE SAVINGS BONDS PURCHASED FOR EDUCATIONAL PURPOSES

- The bonds must be issued after December 31, 1989 to individuals who are at least 24 years old.
- The bonds must be issued in either one parent's name or both parents' names.
- The bonds must be redeemed in the year that qualified educational expenses are paid to an eligible educational institution.
- The exemption applies to more than just the education of your children. It can also apply to your own education or that of your spouse.
- Another restriction involves the income level of the taxpayer purchasing the bonds. The following income limits apply:

Tax Income	*Income	Exemption Applies
Single	\$40,000 or less	Yes
Single	\$40,001 to \$55,000	Partial
Single	\$55,001 or more	No
Married joint return	\$60,000 or less	Yes
Married joint return	\$60,001 to \$90,000	Partial
Married joint return	\$90,001 or more	No
Married separate return	—	No

**Income limits may be adjusted for inflation periodically.*

POOLED FUNDS AT BANKS

Another alternative investment for beginners is to invest with a bank through its trust department. Many banks with trust departments offer pooled funds, known as *common trust funds*, which are similar to mutual funds. A drawback to investing in these funds is the minimum investment, which is \$75.00 at smaller banks and \$200,000 at some of the larger banks.

If you decide to consider this method of investment, be sure to ask the bank to disclose the fund's *true net yield* for at least five years. Let the bank know that the true net yield, should be the fund's yield after bank expenses have been deducted.

Also, remember that these pooled funds are not covered by FDIC

insurance.

SUGGESTED APPROACH

For those persons who fit the category of investors described in the first paragraph of this chapter, CDs, Treasury securities, and U. S. Savings Bonds will not only address their concerns, but also will provide them with investments that are competitive with most other investments. Other investors may not view CDs and Savings Bonds, for example, as the kind of challenge they are looking for in the world of investing, and they may even speak disparagingly of these two instruments as investments. No investor, however, should be ashamed of concerns for safety, paperwork, and fees in connection with investing, as long as the resulting investments meet the investor's goals and objectives.

There is a great deal of merit to sticking with the simplest investments. They are easy to understand, involve very little time to purchase, and require no monitoring during the period of ownership. This approach to investing is highly recommended for many investors. Those who follow this approach may never become billionaires; however, they will not only sleep soundly every night, but they will also wake up each morning better off financially than they were the previous morning.

Footnote

¹[Wall Street Journal](#), November 16, 1988, p. C1.

CHAPTER 4

MAKING MONEY IN THE STOCK MARKET

Read Carefully the Sections on:

- . . . When to Buy, Sell, and at What Price
- . . . Best Dividend Producers
- . . . Options—Be Careful!
- . . . The Confirmation Statement
- . . . You, the Owner of Stocks

CHAPTER 4

MAKING MONEY IN THE STOCK MARKET

If you want to make money in the stock market, you ought to consider two objectives, namely a short-term objective of increasing your cash income immediately, and a long-term objective of acquiring additional cash at some time in the distant future. The distant future could be some time after ten years when your children are ready for college, or some time after thirty-five years when you are ready for retirement. To achieve the short-term objective, you should buy stocks:

- that pay fairly generous dividends. Stocks of utility companies, for example, have a history of paying good cash dividends, and
- those that are expected to increase in price within the next one to two years, so that you can sell them at a profit. Stocks of new companies have a history of affording this opportunity.

To achieve the long-term objective, you should seek the stocks of companies that have been in business for a number of years, whose dividends have been steady, and whose history has been one of slow but marked expansion and growth. One way of achieving these two objectives is to gather all of the available and relevant information on the corporations that issue stocks to the public. Among other sources, this information may come from your broker, friends, newspapers, financial publications previous annual reports of corporations, and various **rating organizations**.

When using this approach to achieve your objectives, you should keep certain factors in mind. For example, when you sense that specific stocks are not fulfilling your objectives, you should trade them for stocks that have greater potential, according to your most recent research. It is a fact that both national and international economies can change very rapidly, and what may have looked like a promising company two or three years ago, may now look very different. The responsibility for knowing when to abandon certain stock and pick up others is a very heavy one. Mistakes not only can be costly, but they derail the achievement of your objectives and lessen your confidence in investing.

EVALUATING STOCKS

To help in determining whether an investment in a particular stock will further your investment objectives, you should review certain information on the stock, such as the price, anticipated earnings, and the dividends. These factors can be evaluated on an aggregate basis or on a per-share basis. Most investors find the latter approach much more convenient.

Price per Share. One reason why it is more convenient to evaluate investments in common stock on a price per share basis is that major daily newspapers always report this particular data in their stock market quotations. An investor who is considering purchasing 200 shares of Pension common stock can easily determine that if the current price per share is, for example \$30, then his total investment would be \$6,000.

Total Return. This is the basic measure for evaluating common stock. It incorporates both the dividend yield and any percentage change in the price of the stock during the year. The dividend yield is expressed as a percentage computed by dividing the dollar amount of the annual dividend by the current market price. For example, if Acme stock is paying a \$2 annual dividend per share and the stock is selling for \$100 per share, the current dividend yield is 2 percent. Also, if the price of the stock during the year increases in price from \$100 to \$110 per share, the gain is \$10, or the stock has appreciated by 10 percent since \$10 is 10 percent of \$100. If both of these developments occur, the total return on the Acme stock would be 12 percent (2% dividend yield + 10% capital gains yield).

Earnings per Share. As the term clearly indicates, a corporation's earnings per share can be calculated by dividing the firm's total earnings by the total number of shares outstanding. As is the case with the above-mentioned price-per-share data, earnings-per-share information is both readily available in the daily newspapers and convenient to use in analyzing an investment in common stock.

Dividends per Share. The relationship between a corporation's total earnings and earnings-per-share is comparable to the relationship between the total dividend payments made by the firm and dividends per share. Total dividends divided by the number of shares outstanding equals dividends per share. Of course, for an individual shareholder, the total dividend payment he or she receives is equal to the firm's dividends per share times the number of shares he or she owns. Suppose, for example, that the Standard Corporation announces in the newspaper that it will return for reinvestment \$800,000 of the firm's \$1,000,000 net profit for 1990. Then, total dividend payments

will be \$200,000 total dividends/100,000 shares outstanding. If Mr. Jenkins owns 5,000 shares, he will therefore receive \$10,000 in dividends (\$2 dividends per share x 10,000 shares).

rating organizations: firms that operate investment advisory services. The firms evaluate the relative worth of particular securities.

Other information that may be helpful to the investor in evaluating common stock includes the following:

Earnings Yield. Even though the stockholder receives directly only that part of the firm's earnings which is paid as dividends, the portion retained for reinvestment should produce a net benefit for the stockholder when this stock is sold. This means of evaluating stock provides a measure of the rate of return on the stock.

Price/Earnings Rates. The financial news often highlights a firm's price/earnings ratio, which is the price per share divided by earnings per share. Basically, this ratio is just another way of interpreting the earnings yield. For example, if an investor buys a stock at \$25 per share, and the annual earnings are \$5 per share, then the earnings yield is found by dividing \$5 by \$25. This produces an earnings yield of 20 percent. To find the price/earnings ratio, you simply convert the 20 percent to 20/100 and use the reciprocal of this figure, which in this case is 5. If the investor could get this same stock for \$20 per share with the same earnings of \$5 per share, the earnings yield would be 25 percent and the price/earnings would be 4. This shows that a stock with a lower price/earnings ratio is preferable to one with a higher price/earnings ratio.

Book Value. An alternative to evaluating stocks on a per share basis is evaluating stocks on the basis of their book value. Book value is generally defined as a company's net worth, which in turn is its assets minus its liabilities. Interested investors can obtain this information from the company's annual report. As a matter of fact, the investor does not need to make any computation because the amount of the stock's book value is usually published along with other key ratios on the company's stock. Investors can find the book value of a company's stock in Standard & Poor's stock guide or in the Value Line Investment Survey.

In choosing stocks to buy, many investors search for stocks whose book value is greater than their current market price. In case the company is dissolved or is broken up and sold in separate pieces, these investors feel that their share of the proceeds will exceed the total paid for the stock. Also, if it is believed that the high book value of the

stock will attract “takeover” attempts, then investors will believe that the “takeover” party will pay a premium for all outstanding stock, thus resulting in a tidy profit for current stockholders. Currently, A. G. Edwards and Sons publishes “Value Investing Update,” a periodic listing of stocks selling below their book value.

The Prospectus

In addition to the sources of information on stocks and the issuing corporations mentioned earlier, a very vital and formal source is the prospectus. This source is available on all initial public offerings (IPO) of stock. The prospectus provides potential purchasers of stock with detailed information on the issuing corporation, the securities being offered for sale, and the proposed use of the proceeds from the sale of the stock. The information also includes the key financial statements of the corporation, such as, the most recent operating statement and balance sheet. Other information may include the governmental agencies that regulate the corporation, the nature of the corporation’s competition, and any pending developments such as labor union negotiations. All such information is designed to help the potential purchaser of stocks to evaluate the stocks before the purchase, and thus should help to reduce the risk in buying stocks.

A TECHNICAL EVALUATION OF RISK

One means of assessing or calculating the risk when buying a particular stock is to use the statistical measure known as the “beta” factor. This factor is not immediately self-evident, but shows the relationship between the movement of an individual stock and that of the overall stock market. It is calculated by looking at the month-to-month fluctuation of a stock’s total return over a three-year period, compared with similar movements of the S&P 500-stock index. For purposes of comparison, the S&P 500 is assigned a beta of 1.00. A stock with a beta of less than 1.00 is less volatile than the broader market. A figure higher than 1.00 means that a stock is more volatile, and thus its reward—is higher. Investors should note that calculating beta takes considerable experience and expertise. Information on beta is usually available at brokerage firms and libraries.

WHEN TO BUY AND SELL, AND AT WHAT PRICE

For many years, stockholders have pondered over the right action to be taken when faced with “When to buy and sell, and at what price.” Some have felt vindicated by steadfastly adhering to the so-called “value approach” pioneered by Benjamin Graham, now considered one of the great investment philosophers and refined by

one of his disciples, Warren Buffett, considered one of the nation's most successful investors. In brief, this approach has come to mean that an investor should buy a stock when it is selling below its book value or balance sheet value, and sell when the market price reaches this value or goes above it. For various reasons, this approach has been very successful in some instances, but less than satisfactory in others.

For most investors, the “common sense approach” can always be used with satisfying results, even if the results are unfavorable. In other words, most investors feel that if they have awareness of economic, financial, and other developments, and a habit of adhering to sound logic, they will benefit from their decisions in the stock market unless a quirk occurs. An example of the common sense approach would be to hold onto or buy stocks of food and pharmaceutical companies during an economic downturn. Why? Well, most investors feel that people will not go hungry or neglect their health regardless of changes in their finances.

Frankly, there is little guidance to be given to a prospective buyer or seller on the “right” time to buy or sell a particular stock or the price at which to buy or sell the stock. Current prospective owners of stocks are constantly evaluating and re-evaluating a firm's prospects in order to obtain the best possible returns on its stock. As conditions in the domestic and international economies, or in a specific industry, change over time, a particular firm's stock may become more or less attractive to a particular investor or to investors in general. These changes in conditions and evaluations lead to changes in the price that investors are willing to pay for a stock. If most investors feel that a particular firm's prospects for future profitability are improving, then the price they are willing to pay for shares in that company will increase. On the other hand, if investors feel that a firm's prospects for future profitability are grim, then the price they are willing to pay for shares in that firm will decline. Thus, it is these changes in conditions and in investors' analyses of the conditions that cause stock prices to increase or decrease, and no individual can be assured of forecasting these changes.

BEST DIVIDEND PRODUCERS

If you need more money now and are willing to enter the stock market, your best bet is to buy utility stocks (stocks issued by companies that sell electricity, gas, telephone service, etc.). Not only do these stocks produce relatively generous dividends, but they also act as a hedge against inflation; that is, the price of the stock tends to rise as inflation accelerates.

In some communities, people who are customers of a utility

company can purchase the stock directly from the company without paying a broker's fee. In Virginia, for example, customers who buy their electricity from Dominion Resources can purchase the company's stock under the company's Stock Purchase Plan without paying any kind of fee or commission.

While experience during the past decade or so indicates that utility stocks are superior to bank certificates or deposit, money-market mutual funds, and even Treasury securities as producers of current income, the investor should still seek information on the company's dividend history and the relationship between the company's common stock and preferred stock. Other useful information could include whether the company has any lingering problems with its nuclear plants or regulatory agencies.

PURCHASING STOCK DIRECTLY FROM ISSUING FIRMS

Other firms that permit first-time investors to buy the firm's stock without going through a broker (and commission-free) include Exxon, Mobil, Texaco, Proctor and Gamble and Johnson Controls. With Exxon, new investors can start with an initial purchase of just \$250 worth of stock.

With most of these plans, there is a commission when the shares of stock are sold; and sometimes a fee is added.

People who would like to buy utility stocks, but would like professional management of such stocks can buy into a utility mutual fund.

OPTIONS-BE CAREFUL!

Warrants, Calls and Puts

As an investment in financial instruments, an option is the right to buy or sell securities at a present price (strike price) within a specified period of time. Simpler forms of options include convertible bonds and convertible preferred stock, both of which were discussed in a previous chapter. The more risky and complex forms of options are commonly known as warrants, puts, and calls.

Warrants. These are often issued by a corporation to its creditors as a means of encouraging the creditor to provide financing to the corporation. A creditor who may be hesitant in extending credit to a corporation might be persuaded to extend the credit if he or she receives warrants for the corporation's common stock. The price of the common stock and the outside date at which it may be purchased at this price are specified for the holder of the warrant. When warrants

are issued, the exercise (or preset) price is usually close to the market price. Thus if the market price rises significantly, the warrant holder can realize a profit by exercising the option to purchase stock at the exercise price and then selling the stock at the higher market price. On the other hand, if the exercise price is above the market price of the stock at the expiration of the warrant period, the warrant will not be exercised and will expire.

Holders of warrants can make money for themselves without ever exercising the warrant. Holders can sell the warrants to investors who predict that the market price of the stock will go even higher. This possibility establishes a market for the warrant itself. To illustrate, assume that a corporation wishing to sell bonds entices buyers by issuing warrants that entitle each buyer of a \$5,000 bond to buy a share of the corporation's common stock at \$18 per share when the stock is issued. If the current market price of the stock is \$20 per share, the holder of the warrant may be able to sell the warrant to another investor for \$1, if that investor predicts that the market price of the stock will exceed \$21. If indeed the market price rises to \$22 when the corporation finally issues the stock, the investor can exercise the warrant and make a \$3 per share profit since his or her total cost will be only \$19 (the \$1 for the warrant and \$18 for the stock). Of course, if the market price falls to \$15, the investor simply loses the \$1 already paid for the warrant.

In addition to the market price of the common stock, variations in the price of warrants may be influenced by: (1) cash dividends paid on the common stock, (2) the expiration date of the warrant, (3) the volatility of the price of the common stock, and (4) the potential **dilution** of the common stock from exercising the warrant.

Calls. These are options sold by individuals that entitle the buyer to purchase stock at a specified price within a specified period of time. In many instances, individuals write calls for stock which they do not own. While calls are similar to warrants in many respects, there are very important distinctions between these two forms of options. First, calls are issued by individuals, whereas warrants are issued by corporations. Second, calls are issued for relatively short periods of time, i.e., 3, 6, or 9 months. Warrants may be issued for periods up to 5 years. A third distinction is that sellers of calls cannot issue new stock when calls are exercised. When warrants are exercised, a corporation issues new stock.

To repeat, a call is usually written by an owner of stocks. The call itself is a contract giving the buyer or holder the right to buy a specific number of shares of stock at a specified price before a specified date.

dilution: a reduction in potential earnings per share due to the of new securities.

Most calls expire without being exercised by the holder, and the call writer earns a profit from the premium or fee charged when the call was originally sold.

A call writer can suffer severe losses when the market price of the stock rises above the striking price or price specified in the call contract. If the stock is in the call writer's portfolio, he or she is forced to forego a profit when the buyer of the call exercises his or her option. If the stock is not in the call writer's portfolio, he or she is forced to buy the stock in the open market, thus paying more for the stock than the price specified in the call. Writing and buying calls can be very risky and should be reserved for only the most sophisticated investors, those who follow market developments very closely.

Puts. This is an option to sell stock at a specified price within a specified period of time. Similar to calls, puts are written by individuals for relatively short periods of time, and sold to other individuals who become holders of the puts. Like warrants and calls, there is a market for puts. The price of puts goes down when the market price of the stock goes down; it goes up when the market price of the stock goes up. Why would an investor buy a put? Consider this. If an investor buys 100 shares of stock, he or she naturally hopes that the price will go up. If it goes down, a loss is incurred. To reduce this risk, the investor can buy a put for a specified price close to his or her purchase price. The total price of the put contract itself might be \$200 (\$2 per share). Thus, if the market price of the stock goes down, the investor could still sell the stock for virtually the same price as he or she paid for it initially. If the market price of the stock goes up, the investor could let the put option expire.

Buyers and Sellers of Options. An individual investor cannot buy an option unless someone is selling it. That seller can either own the underlying stock (covered writing) or sell the option without ownership of the underlying stock (selling naked). Options are not traded between private individuals, but rather through a central clearing operation, namely organized board of exchange, such as, the Chicago Board of Options Exchange. Buying options gives the investor a chance to reap large capital gains with a relatively small investment, and it limits the possible loss to the amount invested. This allows an investor to control more shares of securities for less money.

CONFIRMATION STATEMENT

Under the securities laws, a broker-dealer is required to send an

investor a written notification whenever a transaction has been executed for the customer's account. These written confirmations provide investors with certain valuable information about their securities transactions. A confirmation must include such information as the date of the transaction; the identity of the security purchased or sold; the price received or paid for such security; and the number of shares, units or principal amount of such security. The confirmation must also reflect the time the customer's order was executed, or it must advise the customer that such information will be provided upon request.

A broker/dealer must also disclose the cost of the actual transaction to the customer. For example, a confirmation must reflect the amount of commission or other similar remuneration that the broker has charged the customer for executing the transaction. In addition, the confirmation must state whether any special fee was charged because the transaction involved an odd-lot (less than 100 shares). The amount of that differential or fee must be furnished to the customer upon request.

A confirmation must also indicate whether the broker-dealer is acting as an agent when it executes the transactions for the customer, or as principal for its own account. If the firm is acting as an agent, the confirmation must either give the name of the buyer or seller of the security, or, as is most often the case, include an indication of some kind that such information is available upon request. In the case of brokers whose confirmations are prepared by computerized data processing systems, this indication is usually in the form of a symbol whose meaning is described in the printed material on the reverse of the confirmation.

In many respects, a confirmation statement is like a receipt for the purchase or sale of consumer goods, or for a banking transaction. You should read it very carefully to ensure that it is correct and that it accurately reflects the transaction you authorized. If there is the slightest difference between what you intended to buy or authorized, you should get in touch with the broker immediately. A failure to go on record promptly with an objection to any element of the transaction described by the confirmation, may be taken as a tacit approval of the broker's handling of the transaction.

RECORD-KEEPING

Certificates

When an investor buys stock, a stock certificate may be issued in his or her name if the stock is being sold for the first time, or comes

from the broker authorized to buy the stock from a previous owner. If the stock is purchased from a previous owner, and the stock certificate is delivered to the broker in good deliverable form, then the investor should make certain that the certificate is properly endorsed or accompanied by a separate assignment form known as a **stock power**, which duplicates the form of the assignment printed on the back of the certificate. In either case, the signature endorsement must be exactly the same as the name of the registered owner appearing on the face of the certificate, and the signature must be guaranteed by a national bank or by a broker that is a member of a national securities exchange.

Stock certificates are valuable property, and unfortunately they are often stolen or misplaced. In such instances, the question of how difficult it may be for the investor to obtain a replacement certificate depends largely upon the care with which he or she has maintained investment records.

Ideally, an investor should keep a record of all his or her transactions in a book or file kept separate from the actual securities certificates. In addition to information about cost and name of the brokerage firm where the securities were purchased, the certificate number or numbers for all the certificates received should be recorded. By doing this, the investor assures that, if a certificate is missing, he or she will have the proper information to give to the **transfer agent** so that the certificate can be recorded as lost (to prevent an unauthorized transfer) and he or she can file the proper papers to obtain a replacement.

stock power: written authority to act in the place of person whose name is on the stock certificate.

transfer agent: a bank that keeps the corporation's record of stockholders and transfers the stock certificates as they are bought and sold.

If you think you may have lost or misplaced a certificate, you should check your records and inquire of the transfer agent, if known, or your broker to make sure that a "stop transfer" is placed against your missing shares.

Bear in mind that you will in most cases be required to pay for any indemnity (insurance) bond to protect the transfer agent against loss should a replacement certificate be issued in your name. If the transfer agent has no record of your name, it means that the security, in all likelihood, has been transferred from your name to someone else's name. If this happens, your only salvation is to furnish the serial number of your original certificate. If you cannot locate the number of

the original certificate, the transfer agent will not consider a request for a replacement. To eliminate the risk of misplacing stock certificates, many investors prefer to leave their certificates on file in their brokers' offices.

If you have any questions concerning lost or stolen stock certificates, you may contact the Office of Consumer Affairs and Information Services, Securities and Exchange Commission, Washington, D. C. 20549.

Purchases and Sales

In addition to maintaining a file for stock certificates, the record-keeping system should include files on the purchase and sales of stocks. Data on the purchase and sale price of a particular stock are needed to determine the "basis" for the stock when it is sold. The basis usually refers to the cost of the stock, and this cost, in turn, is required to calculate the capital gains or loss on the sale. Capital gains or losses must be reported when investors file their income taxes.

Records on the purchase and sale of stocks can be as voluminous as the investor desires. The basic records, however, would consist of a file on all Stock Confirmations, Bond Confirmations, "and Mutual Fund Purchases," along with "Sales Confirmations" on the same securities. The capital gain or loss is derived when the purchase confirmations for each stock are matched with sales confirmations for that stock. The broker's commission should be added to the gross purchase price of the stock in determining the "basis for use in computing the capital gain or loss.

YOU, THE OWNER OF STOCKS

Experience shows that the ownership of stocks can be a very satisfactory investment. Some investors achieve their objectives in a "bull market," namely when stock prices are generally increasing. Others achieve their objectives in a "bear market," that is, when stock prices are generally declining. This chapter, however, speaks mainly to those investors who want to buy stocks as a long-term investment, one that is expected to produce some income, while accumulating value during the future.

As an investor, you should have certain objectives in mind when considering stock as investment. The purchase of stocks may partially satisfy your overall objective or achieving diversification in your investment portfolio. Your precise objectives for becoming an owner of stocks, however, should go much further. You ought to view your ownership of stocks in relation to such matters as your need for income, your desire for an investment that can appreciate in value,

the characteristics of alternative investments, your preference for an investment with reasonable liquidity, and your capacity and willingness to take risk.

CHAPTER 5

HOW TO WORK WITH STOCKBROKERS

Stresses the Following:

- . . . How to select a broker
- . . . What's involved in opening an account with a broker
- . . . Broker's commissions
- . . . Value of dealing with discount brokers
- . . . Process of handling disputes with brokers
- . . . The meaning of arbitration
- . . . Protection for the investor

CHAPTER 5

HOW TO WORK WITH STOCKBROKERS

Whenever you are out among friends and the conversation turns to stocks and the stock market, you are likely to hear a few pros and cons on these two topics, but a lot more about those individuals who operate between you and these two topics. I am referring to those professionals known as stockbrokers. Examples of some of the comments you are likely to hear about stockbrokers are:

- . . . “I believe my broker is making more profit off my money than I am.”
- . . . “How can I tell if my broker is churning my account?”
- . . . “My broker always looks out for me.”
- . . . “Does a broker make money both ways? By that I mean, does he make money for himself when the stock market is going up and going down?”
- . . . “My broker is always calling me or sending me something in the mail. Is he trying to help me or himself?”
- . . . “My latest statement from my broker states that my stocks are worth only half of what I paid for them, but he never called me about them”
- . . . “Who is your broker and how do you like him? Does he really make money for you?”

As you can see, some of these comments are favorable, some are not favorable, while others merely raise understandable questions about the actions, behavior, and motives of stockbrokers. So, perhaps what we need to do is to learn more about these individuals and how to work with them.

AN ORIENTATION ON STOCKBROKERS

Basically a stockbroker is a person who brings together individuals or organizations wishing to buy and sell securities. Although any potential buyer and seller of an asset is free to enter a transaction without the aid of another person, a stockbroker can offer a service

that may benefit both parties in this transaction. Today's stockbrokers have access to equipment that links them not only to buyers and sellers throughout the world but also to substantial analytic resources as well. In a matter of seconds, stockbrokers can summon the latest data on stocks, bonds, mutual funds, and various kinds of options. On stocks, in particular, stockbrokers can provide investors with up-to-the-minute information on yields, dividends or earnings, market volume, and indexes or averages. In other words, stockbrokers can provide investors with all of the information that they need to make informed decisions about their investments. Stockbrokers are also called account executives and are referred to as registered representatives when they pass a *Series 7* exam and are registered with the SEC.

STOCKBROKERS AND INVESTMENTS

- . . . Only a stockbroker can execute an investor's order to buy or sell stocks.
- . . . In addition to buying and selling stocks and bonds for an investor, a stockbroker can arrange for investments in mutual funds, insurance-company products and tax-sheltered investments.

For information on the broker's character and his or her disciplinary record, the investor can write to the National Association of Securities Dealers (NASD) or telephone the organization's toll free number: 800-289-9999. This organization keeps track of settled disciplinary actions taken against brokers, particularly brokers registered with the New York Stock Exchange. The Stock Exchange maintains-RE3 and U5 reports on brokers. An RE3 report is generated after a broker has settled a dispute with a customer. A U5 report is filed after a broker is dismissed from a brokerage firm, and this report lists the reasons for dismissal.

SELECTING A BROKER

Needless to say, your choice for a broker should be one that has an excellent record of advising customers on investments, inviting customers to ask questions about this advice, maintaining close and personal contact with customer on investments, and playing a key role in helping customers to achieve their financial objectives. Such a broker is not going to drop from heaven. The investor must utilize contacts with bankers, close friends with experience in investing, consume-oriented agencies (both public and private), and current

customers of the particular broker.

In selecting a broker, the investor should consider the kind of service needed from the broker. If the investor wants someone to research and recommend specific investments, provide custody accommodations for securities, lend them money for buying securities on margin, monitor their investments, and generally maintain close and personal contact with regard to the investments, then the need is for a *full-service broker*. If on the other hand, the investor feels that he or she has enough experience to make an investment decision without advice and only needs someone to execute the transaction, then such an investor may well select a *discount broker*.

Full-Service Brokers

If you decide that you need the services offered by a full-service broker, you should initiate the relationship by opening an account with his or her brokerage firm. Opening an account with a brokerage firm is similar, in many respects to opening a bank account or a credit account with a department store.

To start, an account executive will be assigned to handle your account. Your account executive may arrange to open your account by telephone, by mail or through a visit to the brokerage firm's office. The new account application requires among other things, your name, address, age, social security number, business address, employer, occupation, bank and/or credit references, and, in most instances, some information about your financial resources and income. Your account executive will also ask about and discuss with you your investment objectives and the degree of risk or other financial limitations you may have. These questions usually appear on a document entitled, "Investor's Questionnaire." The investor should retain a copy of this document. Further, if this document does not describe specifically or adequately the investor's goal, strategy, limitations, etc., the investor should put these factors in writing for the broker and retain a copy for his or her own files.

STOCKBROKERS AND INVESTMENTS

Investors usually have one or two basic type of accounts with a brokerage firm.

- CASH—you must pay in full for all securities purchased at the time of the transaction.
- MARGIN—you may purchase securities on credit, with a loan from the brokerage firm.

If you choose not to furnish certain personal information to the

broker, the brokerage firm may refuse to open an account in your name. This is because the broker is obligated to obtain the essential facts relative to each customer, in order to comply with a number of rules which are designed for a customer's own protection.

Discount Brokers

You may determine that you do not need all of the services provided by a full-service broker. You may conclude that all you need is for some properly licensed individual to execute your transactions in the stock market. If this is the case, then all you need is a discount broker.

Because discount brokers do not offer the array of services provided by full-service brokers, they naturally do not charge their customers as much for buying and selling stocks as full-service brokers do. Most discount brokers are able to operate with very limited staff. As a matter of fact, many commercial banks serve as discount brokers with only one staff person assigned to handling stock transactions.

It goes without saying that investors should have experience in the stock market before relying exclusively on discount brokers. Discount brokers provide no research on stocks and make no recommendations on which stocks to buy and sell. Once the stock has been bought or sold, there is no further communication between the broker and the investor on that transaction.

One factor that every individual or organization should consider when engaged in the activity of buying and selling stock is the transactions cost. When this cost approaches the point where it begins to encroach significantly on the profitability of the transaction, then the buyer or seller should think seriously about an alternative means of executing this transaction. And so it is with the broker's commission, which is the major portion of the cost in buying and selling stocks. In most instances, the broker's commission for buying or selling 100 shares of stock is the same as it is for selling 30 shares of stock. This means that the commission for selling the 30 shares is equal to a larger proportion of the profit made on selling these shares. In some cases where the transaction involves a very small number of shares, the commission might even be greater than the profit. With this in mind, it pays for investors to consider dealing with discount brokers when the investor needs no advice on what stock to buy or sell and does not require any services beyond executing the transaction. On the other hand, if the investor is trying to increase his profits by buying stock on the margin or selling stock short, he or she needs the services of a full-service broker and should be willing to pay the appropriate commission for these services.

BROKERS' COMMISSIONS

For many years, the commission rates which stockbrokers charge their customers for buying or selling securities, were established by a schedule of minimum rates set by national securities exchanges for their members and adhered to by most brokers. Rates were thus “fixed” throughout the industry, and the individual investor would pay pretty much the same commission regardless of which broker he went to for a particular transaction.

But in May 1975, the Securities and Exchange Commission (“SEC”) adopted a rule that eliminated the provision on fixed commission rates. Today, brokerage firms are able to compete with each other to offer customers the best combination of rates and services, just as do most businesses. Consequently, commission rates that are available to investors may vary greatly. A broker should be willing to give a potential customer a list of the commissions that he or she will charge on a purchase or sale of securities.

The rates of commission charged by brokers may vary not only from firm to firm, but also within a particular firm, depending on such factors as the size of the transaction, the volume of business done by the customer, the various services which the broker/dealer may provide or perform for the customer, or a combination of these and other factors. Investors should feel free to request a full explanation of rates and to shop around for the combination of rates and services most suited to their needs.

COMMISSIONS AND FEES

. . . Each time you buy or sell stocks (or other investment products) through a stockbroker, a portion of this goes to the broker and the remainder to the broker's firm.

The customer should also be aware that if he/she does not place an “all-or-none” order, which is an order to buy or sell more than one round lot of stock at one time and at a designated price or better, a commission will be charged for each separate round lot executed and a differential, i.e., usually one-eighth of a point, will be charged on any odd-lots executed. For example, if you place a regular market order to buy 265 shares of a particular security, 100 shares may be executed at one time triggering the odd-lot, and 100 shares at a later time. You would pay a commission on each of the 100 share executions and a differential on the 65 shares odd-lot. If the same 265 share order were placed on an all-or-none basis, the 200 shares would have to be executed at the same time and price, only one commission

would be charged, and the one-eighth point differential would usually not be charged on the 65 share odd-lot.

A growing number of brokerage firms are levying special fees on investors who fail to generate sufficient commission income. The fees are commonly referred to as “inactive-account” fees, and they are supposedly intended to offset the cost of the custodial services that these firms provide investors who leave their securities on deposit in a brokerage account. The fees do not apply to investors who hold their own stock and bond certificates or to customers with money-management accounts. Such fees range from \$30 to \$50 per year. In addition to inactive-account fees, a number of brokerage firms are charging investors for postage and handling when the firms send out confirmation statements for transactions.

This is not to say that the various fees charged by brokers are unwarranted. Experience shows that just providing the custodial services to maintain a brokerage account— including clipping bond coupons, collecting dividends, printing and mailing monthly statements, and sending quarterly reports to investors— cost the brokerage firm about \$29 a year. In addition, investors often get consulting service from brokers by telephone.

Regardless of the services provided, all broker-dealer firms must be registered and conduct their business in accordance with the Securities and Exchange Act of 1934 and the rules issued under that Act by the SEC. It is important to remember that charges for services are not fixed by the SEC or by any exchange. Upon deciding to buy stock through a full-service broker, you should ask him or her about the services that the firm provides free and about all the services for which there is a charge.

State Registration

Most states require the registration, generally in the form of some type of license, of a firm and its salespersons engaged in offering and selling securities to customers within the state. In some states, qualification examinations, photographs, fingerprints, and insurance bonding may be required as a condition to registration. Individual registration are issued for varying periods and purposes and subject to renewal or periodic updating. Persons offering investment advice may also be subject to registration under state law.

SETTLING DISPUTES

Within the Same Firm

Despite the satisfactory experience that millions of investors are

enjoying with their brokers, disputes between the two groups are commonplace. Fortunately, most of these differences result from either lack of communication between the two groups or lack of clarity in their communication with each other. To lessen the chances of problems in communication, most brokerage firms, upon accepting an investor as a client, require written confirmation on key data on the client, such as, the client's income, equity, investment goals, and prior investment experience. Indeed most disputes between brokers and investors are settled promptly and without rancor. There are still instances, however, in which the dispute becomes frustrating to both parties, and thus some type of adjudication becomes necessary.

SOURCES OF MOST DISPUTES

Investor: Seeks to recoup investment losses alleged to be caused by broker's action, inaction, and advice.

Brokerage Firm: Seeks to collect on debit balance when fluctuations in the stock market wipe away the equity in the investor's margin account.

Most disputes between brokers and investors involve charges that the broker is **churning** the investor's account, engaging in unauthorized trading in the account, or advising the investor to buy securities that are unsuitable for his or her investor status. When these disputes occur, and referral to the brokerage firm's branch manager fails to resolve the matter, then further steps become necessary.

It is very important for investors to understand that they must furnish adequate evidence to support any dispute with a broker. For example, a dispute involving churning means that the investor is charging the broker with excessive buying and selling of securities in the investor's account for the sole purpose of earning commissions for the broker. To substantiate this charge, the investor must:

1. show that the broker controlled the account.
2. document the excess activity, and
3. prove that the activity was conducted for the sole benefit of the broker and not the investor.

churning: This describes the actions of brokers who buy and sell securities excessively in a customer's accounts for the sole purpose of earning increased commissions.

To Another Firm

If the investor is dissatisfied with the broker's judgment, attitude, attentiveness, and advice, and does not seek any kind of monetary relief, he or she may try to arrange to have the account transferred to another brokerage firm. Unfortunately, this action is not always effected promptly, thus causing the investor some anxiety about the status of his or her account. Delays can be caused by the broker's failure to collect and to handle all the appropriate records efficiently or the investor's failure to provide all the appropriate information.

An investor who wishes to transfer an account from one brokerage firm to another must submit to the receiving (new) broker a completed Customer Declaration of Ownership and Authority to Transfer and Receive Account (TRC). This document requests the usual information, such as the investor's name and account number, type of account, the debit and credit balance, and certain data for each security such as the quantity and description. Since the TRC is necessary to facilitate a rapid and orderly transfer, it consists of an original copy for the receiving broker, copies for various internal operations departments, copies for the former broker and a copy for the investor. The new broker will submit a copy of the TRC to the former broker. The former broker will then acknowledge (usually within five days following receipt) that the account is accurately represented and return to the new broker a validated copy of the TRC. The new broker will execute any purchase transactions for cash after the new account documentation has been received. He or she will normally begin to execute purchases against credit balances, and sales of securities after the TRC has been validated by the former broker.

There can be a penalty of \$500 for inability of the former broker to transfer a regular account within 10 business days. Complaints by the investor can be lodged with the regional office of the SEC, or its Office of Consumer Affairs at 450 Fifth Street, N. W., Washington, D. C. 20549. Either of these offices will reach one or both brokers and request a report, often bringing the problems to self-regulatory organizations.

Although the SEC is authorized to assist an investor in obtaining an explanation for a delay in transferring an account, the agency is not authorized by Congress to intervene directly on behalf of individual investors in the assertion of their personal rights or claims. The SEC does find such information useful in monitoring the activities of brokers and other securities professionals.

ARBITRATION

Most problems between investors and brokers can be resolved through patience and communication between the parties or within the same brokerage firm. There are instances, however, in which the

entry of a third, or neutral, party is needed to resolve the differences. The securities industry has an arrangement by which serious disputes and protracted controversies can be settled by arbitration. The dictionary defines arbitration as “the process by which parties to a dispute submit their differences to the judgment of an impartial party appointed by mutual consent or statutory provisions.” Investors often sign an agreement when they open a brokerage account, binding them to accept arbitration rather than filing a lawsuit if a dispute arises. The National Association of Securities Dealers and the New York Stock Exchange handled about 94 percent of all arbitration cases filed in 1990. Since 1980, the percentage of cases won by investors has varied from about 48 percent to 55 percent.

If you as an investor decide on arbitration as a way of resolving a dispute with your broker, be sure to read the fine print on the brokerage contract. Some brokerage firms require customers to put their claims in writing before taking any action. Failing to do so could provide the firm with an argument that the arbitration claim was improperly filed. As a result of court decisions most securities disputes are now arbitrated pursuant to pre-dispute arbitration agreements, making these agreements enforceable.

Disputes with brokers/dealers often involve complicated issues which in the interest of fairness, require a prompt and inexpensive means of resolution. Because of this, arbitration has long been used as an alternative to the courts. It must be noted, however, that there are certain laws governing the conduct of an arbitration proceeding that must be observed. Most importantly, perhaps, is the fact that an arbitration award is final; that is, the decision is subject to review by a court only on a very limited basis. It should be recognized, too, that in choosing arbitration as a means of resolving a dispute, the parties give up their right to pursue the matter through the courts.

If you are an investor and your dispute involves \$5,000 or less, there is a simplified arbitration procedure, and you should contact the Director of Arbitration at one of the organizations listed in Exhibit 5-1.

Securities Industry Organizations with Arbitration Facilities

To obtain further information, please contact the Director of Arbitration at one of the following organizations:

- | | |
|---|--|
| ☐ American Stock Exchange, Inc.
86 Trinity Place
New York, New York 10006
(212) 306-1000 | ☐ Municipal Securities
Rulemaking Board
1818 N. Street, N.W.
Suite 800
Washington, D.C. 20036
(202) 223-9347 |
| ☐ Boston Stock Exchange, Inc.
One Boston Place
Boston, Massachusetts 02108
(617) 723-9500 | ☐ National Association of Securities
Dealers, Inc.
Two World Trade Center
98th Floor
New York, New York 10048
(212) 839-6251 |
| ☐ Chicago Board Options
Exchange, Inc.
LaSalle at Van Buren
Chicago, Illinois 60605
(312) 786-5600 | ☐ New York Stock Exchange, Inc.
11 Wall Street
New York, New York 10006
(212) 623-3000 |
| ☐ Cincinnati Stock Exchange, Inc.
205 Dixie Terminal Building
Cincinnati, Ohio 45202
(513) 621-1410 | ☐ Pacific Stock Exchange
Incorporated
301 Pine Street
San Francisco, California 94104 |
| ☐ Midwest Stock Exchange,
Incorporated
One Financial Plaza
440 S. LaSalle Street
Chicago, Illinois 60605
(312) 663-2222 | ☐ Philadelphia Stock Exchange, Inc.
1900 Market Street
Philadelphia, Pennsylvania 19103
(215) 563-4700 |

PRINCIPLE OF ARBITRATION

... It was Aristotle who wrote:

“equity is justice in that it goes beyond the written law. And it is equitable to prefer arbitration to the law court, for the arbitration keeps equity in view, whereas the judge looks only to the law, and the reason why arbitrators were appointed was that equity might prevail.”¹

¹ *The Arbitrator's Manual*, i see *infra* notes 335-36.

Eligible Disputes. In considering whether to initiate arbitration, it is important to keep in mind that, generally, the arbitration facilities of the sponsoring organizations are available only for the resolution of disputes relating to or arising out of the activities of broker/dealers. You have a right to require a broker/dealer to submit such disputes to arbitration.

A controversy is not eligible for submission to arbitration if six or more years have elapsed from the date of the event giving rise to the

dispute. However, the arbitrators may dismiss a claim barred by shorter applicable state or federal statutes of limitations.

Initiating Arbitration. To begin arbitration you (the “investor–claimant”) must do these things:

- *Claim letter*—File with the Director of Arbitration three copies of a typewritten or printed letter stating your claim. This letter should set forth the details of your dispute, include all relevant dates and names, in a clear, concise, and chronological fashion, and should conclude by indicating what relief (e.g., money damages in a specific amount performance of a particular agreement, etc.) is being requested of the arbitrators. You may attach copies of documents and supporting materials to your claim.
- *Submission Agreements*—Complete and return three copies of the Submission Agreement provided by the sponsoring organization. By signing the Submission Agreement, you agree to submit the dispute to arbitration and to abide by the decision (the “award”) of the arbitrators. You also agree to be bound by the decision of the arbitrators with regard to any related counterclaim (a claim against the claimant) which may be brought by an opposing party.
- *Deposit of Fees*—Deposit a check or money order made to the sponsoring organization for the appropriate fee. This is only a deposit. All but \$25 will be refunded if the matter is resolved by the parties before the first hearing (See Table 5–1). If a hearing is held, the arbitrators will decide if your deposit should be refunded.
- *Counsel*—State whether or not you will be represented by counsel and, if so, counsel’s name and address.
- *Location*—State where you want the case to be heard and reasons for that choice. The actual decision as to place of hearing resides with the **Director of Arbitration**. Arbitrators can be impaneled in many of the major urban areas throughout the country, but consideration will generally be given to a number of factors, including the convenience of the parties, the availability of qualified arbitrators.

Director of Arbitration: a person who handles administrative matters in arbitration proceedings

- *Arbitrators*—Request a panel to decide the dispute. Unless a public customer requests a panel consisting of a majority of arbitrators from the securities industry, the panel selected to

decide the dispute will be composed of a majority of persons from outside the securities industry.

Once assemble, this material should be submitted to the Director of Arbitration of the sponsoring organization at the address listed in Exhibit 5-1.

Once your claim has been received, the Director of Arbitration will send it to the opposing party or parties (the “respondent”).

Table 5-1
SCHEDULE OF FEES Customer Claimant

Amount in Dispute (Exclusive of Interest Expenses)	Claim Filing Fee	Hearing Session Deposit		
		Simp.¹	1 Arb.²	3 + Arbs.³
\$0.01 – \$1,000	\$15	\$15	\$15	NA
\$1,000.01 – \$2,500	\$25	\$25	\$25	NA
\$2,500.01 – \$5,000	\$50	\$75	\$100	NA
\$5,000.01 – \$10,000	\$75	\$75	\$200	NA
\$10,000.01 – \$30,000	\$100	NA	\$300	\$400
\$30,000.01 – \$50,000	\$120	NA	\$300 ⁴	\$500
\$50,000.01 – \$100,000	\$150	NA	\$300 ⁴	\$750
\$100,000.01 – \$500,000	\$200	NA	\$300 ⁴	\$1,000
\$500,000.01 – \$5,000,000	\$250	NA	\$300 ⁴	\$1,500
Over \$5,000,000	\$300	NA	\$300 ⁴	\$1,500

¹Simplified Arbitration (Without Hearing)

²One Arbitrator (Per Hearing Session)

³Three or More Arbitrators (Per Hearing Session)

⁴Prehearing Conferences Only

Source: National Association of Securities Dealers, Inc., *A Code Arbitration Procedure*, July 1990.

Following the receipt of your claim, the opposing party has 20 business days to provide an answer unless additional time has been granted by the Director of Arbitration. The opposing party may assert

a related **counterclaim** as part of his or her answer or may file a claim against a third party (a claim against another person who may bear responsibility for any of the alleged damages). The opposing party may attach copies of documents and supporting material to the answer. The Director of Arbitration will send a copy of the answer to the claimant who has the business days following receipt of the answer to file a reply to any counterclaim.

counterclaim: a claim against the claimant.

You should make every effort to prepare your case in advance of the hearing so that it may be resolved promptly and justly, and you should also arrange for your witnesses and evidence to be available for presentation to the arbitrators at the hearing. The parties are encouraged to cooperate in the voluntary exchange of such documents and information as will serve to expedite the arbitration. If the parties agree, they may even submit these documents to the Director of Arbitration for forwarding to the arbitrators prior to the hearing.

UNDER THE UNITED STATES ARBITRATION ACT

(Federal Arbitration Act or Arbitration Act), agreements to arbitrate future disputes are, in general, specifically enforceable.

Arbitration decisions are usually final.

When the arbitrators have reached their decision and have signed an award, copies will be mailed to the parties. Arbitrators are not required to provide reasons for the award. The decision of the arbitrators is final; that is, the decision is subject to review by a court only on a very limited basis.

PROTECTION FOR THE INVESTOR

Since the Depression, Congress has enacted a number of measures, including the Securities Act of 1933 and the Securities Exchange Act of 1934, that have been designed to stabilize the stock market to protect investors.

Continuing in this tradition, Congress in 1970 passed the Securities Investor Protection Act (SIPA) and established the Securities Investor Protection Corporation (SIPC) as an industry-funded, nonprofit, membership corporation that offers limited protection to investors.

As of year-end 1986, SIPC had 11,305 members, including all firms registered as broker-dealers with the Securities and Exchange Commission (SEC) and all members of the national securities

exchanges.

SIPC as Agency

SIPC is not a regulatory agency; instead, it is subject to SEC and Congressional oversight. It has a board of seven directors who serve three-year terms. The directors include one representative each from the Board of Governors of the Federal Reserve System and from the Department of the Treasury, three individuals associated with different aspects of the securities industry, and two individuals (one of whom serves as the chairman) not associated with the securities industry. The latter five individuals are appointed by the President of the United States and confirmed by the U. S. Senate.

Investors and “Failed Firms”

SIPC was created to promote investor confidence in the securities industry by insuring customers of failed broker-dealers against losses due to missing cash and securities. Currently, the protection limit for a customer against loss totals \$500,000. This limit includes \$100,000 of protection against claims for cash. Of course, securities on hand that are identifiable as fully-paid-for property of customers need no protection and are returned to customers.

The term “customer” is intended to refer to individuals or firms with claims on the broker-dealer arising out of ordinary business dealings. Such dealings include purchases or sales of securities or the safekeeping of securities and any cash balances maintained for purchases or sales.

A “failed firm” is defined as one that is declared bankrupt, that is forced into liquidation or receivership by any agency of the United States (or any state), that is in violation of the Securities Exchange Act or the rules of the firm’s self-regulatory agency, or that is unable to establish its compliance with applicable laws and rules. Faulty record keeping, often accompanied by fraud, appears to be one of the most prominent factors leading to the demise of members of SPIC. Poor record keeping also often causes some delay in the settlement of customers’ claims.

Dealing with “Failed Firms”

A failed firm is brought to SIPC’s attention by the SEC or the relevant self-regulatory agency (such as the NYSE, the American Stock Exchange [AME], or the National Association of Securities Dealers [NASD]). In most cases, unless the failed firm is merged into an ongoing firm that agrees to assume the losses of customers, the failed

firm simply is liquidated. Most liquidations are not performed directly by SIPC, but rather under the direction of an SIPC-appointed or court-appointed trustee. The difference on the filing date between the market value of the securities or cash claims of customers (less securities or cash owed by customers) and the value of the failed firm's holdings is satisfied out of the SIPC fund.

This procedure differs from an ordinary bankruptcy proceeding because SIPC stands ready to pay customers in full at once; in bankruptcy proceedings, claimants of failed firms must stand in line for a pro rata distribution as trusteeship or receivership proceeds. Although SIPC protection covers most types of securities (including stocks, bonds, notes, and CDs), commodity contracts and commodity options are not covered.

THE INVESTOR'S DECISION

Selecting a broker may well be the most important decision that an investor makes. In many respects this decision is analogous to that of a university board of trustees in selecting a president, and the owner of a professional football team in selecting a coach. To dramatize the importance of the decision even further, let us not forget the old saying, "if you don't know jewelry, be sure you know the jeweler."

Like most other things, stockbrokers can be evaluated with the well-known classifications of excellent, good, fair, passing, and failure. Fortunately, experience, as evidenced by the number of arbitrations, lawsuits, complaints to brokerage firm managers and regulators, and continued reliance on brokers, indicates clearly that most stockbrokers fit into the first two of these classifications. In the final analysis, each investor must select a stockbroker and evaluate the stockbroker on the basis of their particular experience.

Although stockbrokers are privy to much more information about the marketplace for stocks than individual investors, this does not mean that investors should refrain from asking questions about stocks suggested by the broker or hesitate to ask for explanations about certain transactions. The excellent stockbroker will respect both of these privileges and will invite further suggestions to improve the broker-investor relationship.

Above all you should not sign any agreement that creates a discretionary account which gives the broker total control of your account. You may consider giving the broker the authority to sell securities from your account if the price drops below a specific target. But it is inadvisable to give anyone authority to trade in your account without your express approval of each transaction.

CHAPTER 6

A STEADY FLOW OF MONEY: INTEREST FROM CORPORATE BONDS

Objectives are to:

- . . . Review the types of bonds
- . . . Provide you with sources of information about bonds and confidence in choosing bonds as an investment
- . . . Explain “junk bonds”
- . . . Explain the prices, quotations, and yields of bonds
- . . . Describe “Ginnie Maes”
- . . . Explain the risks associated with investing in bonds
- . . . Discuss bonds as an investment

CHAPTR 6

A STEADY FLOW OF MONEY: INTEREST FROM CORPORATE BONDS

A STEADY FLOW OF MONEY: CORPORATE BONDS

Technically a corporate bond is a contract of indebtedness issued by a corporation that promises to pay the principal and interest on specified dates in the future. The corporation is often referred to as the issuer of the bond. When the investor buys the bond, he or she becomes a creditor of the issuer. All bonds have three elements: the principal, term, and rate. All three of these elements appear on the bond certificate. The *principal* is the amount of money that the issuer is borrowing; this amount is also referred to as the face value and the par value. The *term*, or maturity of the bond, is the length of time for which the principal is borrowed. The *rate* is a percentage of the principal and is the fixed interest that the issuer promises to pay you for using your money.

Those investors who want greater certainty of income at regular periods of time and the eventual return of the par value of their investment should seriously consider investing in commercial bonds. The amount of interest earnings on these bonds remains constant; these amounts are usually payable every six months; and the corporation issuing the bonds is obligated to return the principal to the bondholder at the end of the term. Commercial bonds are usually issued in denominations or par value amounts of \$5,000.

Investing in corporate bonds gives the investor certain advantages over the investor in stocks. Investors in bonds are creditors of the corporation, and, as creditors, bondholders receive their interest earnings before stockholders get anything. Stockholders are owners of the corporation and their dividend earnings are largely dependent upon whether the corporation makes a profit.

Investors in corporate bonds can make money on their investment

in at least two ways. One way, of course, is through the receipt of interest. For example, when an investor buys a bond for the par value amount of \$5,000, with a rate of 8 percent, and a term of twenty-years—assuming that he or she keeps the bond for the full twenty-year term—he or she will receive interest income of \$400 (\$200 at the end of each six-month period) each year for twenty years. At the end of twenty years, he or she will receive the \$5,000 paid initially for the bond. The other way is to buy a bond at discount, meaning that your purchase price is below the principal on the bond certificate. You will receive not only a higher yield on your investment, but will reap an additional profit if you hold the bond until maturity. On the other hand, if you buy the bond at a premium, meaning that your purchase price is above the principal on the bond certificate, or par value, you will receive a lower yield, but the full par value if you hold the bond until maturity (see Exhibit 6-1).

Exhibit 6-1

How Your Purchase Price of a Bond Changes Your Annual Yield Par-Value \$5,000: Interest Rate-8%: Term-20 Years			
Purchase Price	Annual Interest	Annual Maturity	Receive at Yield
\$5000	\$400	\$5000	8%
\$4000	\$400	\$5000	10%
\$6000	\$400	\$5000	6 2/3%

TYPES OF BONDS

Corporate bonds are commonly classified by forms of ownership for the investor and by the kind of collateral that the issuer uses to secure the loan. Added to these two basic classifications is the *convertible bond* that can provide investment characteristic of both a bond and a share of common stock.

Ownership Forms

For the buyer or investor, bonds are issued in two forms of ownership, *coupon* or *reregistered*. Coupon bonds, often referred to as *bearer* bonds, are always owned by the person who holds the bonds physically. These bonds can be transferred from one investor to another by simply handing them over, which is one reason coupon bonds are so marketable.

Coupon bonds are so named because they have actual coupons

attached to the bond certificate. Each coupon includes the interest payment amount and interest payment dates. When the interest payment date arrives, the owner presents the coupon to the issuer's paying agent (usually a bank) for payment. When the maturity date arrives, the owner presents the bond certificate itself to the issuer's paying agent for the collection of the principal. Buyers of coupon bonds ought to make sure that their bonds are kept in a secure place (preferable a safe-deposit box at a bank), because whoever has possession of the bonds is the owner.

Registered bonds are so named because the name of the owner is recorded on the issuer's books. When registered bonds are issued, the ownership or title to each bond can only be transferred by proper endorsement, with signature guarantees. Interest payments on registered bonds are mailed by the paying agent directly to the owner of record. The owner of a registered bond is better protected against physical loss than the owner of a coupon bond because the legal title to the bonds is recorded with the issuer.

Collateral Forms

There are two types of bonds that are identified on the basis of the collateral pledged as security for the loan. One is a *secured bond* because the issuer pledges a tangible asset to insure payment. When the collateral consists of real estate, such as buildings, the secured bond is often referred to as a *first mortgage bond*. If the assets are securities of other firms, notes receivable, or accounts receivable, the secured bond is often referred to as a *collateral trust bond*. When the issuer pledges no collateral the bond is called a *debenture*. For the most part, debentures are issued only by well-known firms, because the only backing for the loan is the company's good credit reputation.

Convertible Bonds

This is a hybrid security, because, like any other bond, it pays a stated rate of interest for a fixed period of time; yet, unlike a classic bond, it can be redeemed at any time at the holder's option for a fixed number of shares of the issuing company's common stock. Often, this type of bond carries a lower rate of interest than both the secured bond and the debenture.

Like all securities, convertible bonds have both advantages and disadvantages for the investor. Many investment professionals view these bonds as defensive investments because they are particularly attractive when the investor is uncertain of the direction of the financial markets. Unfortunately, convertible bonds are no advantage when prices of stocks and bonds are declining. They merely protect

investors when stocks or bonds are losing value.

It is also significant to understand why convertible bonds are often referred to as *convertible subordinated debentures*. The reference speaks to the position of the holder as a creditor in the event of the issuing company's dissolution. As a creditor, the holder of these bonds typically stands behind the holders of non-convertible bonds.

SOURCES OF INFORMATION AND CONFIDENCE

Like stocks, the primary source of information about corporate bonds is the prospectus of the issuer. This document is prepared and made available to prospective investors at the time of an issue's initial offering. Again, like stocks, the SEC regulates both the contents of the prospectus and its distribution. A prospectus is not likely to be available for corporate bonds that sold after the initial offering. However, prospective investors interested in such bonds can obtain information from other sources. Rating services such as Moody's Investors Service, Inc. and Standard & Poor's Corporation publish documents on various corporations, and they may be purchased by anyone. Among other things, these documents usually summarize the key features of a corporate bond. Also, many securities dealers who participate in the corporate bond market prepare documents describing the features of various banks.

If you are very concerned about the safety of your investment in bonds, you should not place too much emphasis on the type of collateral pledged on the bond. Rather you should give priority to the credit rating of the issuer. In other words, if you are considering the purchase of corporate bonds, you should first check the issuer's credit rating to see if you will feel comfortable about the corporation's ability to pay interest on schedule and to return the principal when the bond matures. A good guide to the credit-worthiness of corporations are the ratings given by the aforementioned rating service firms. For Standard & Poor's, the highest rating is AAA; next is AA; next is A; and next is BBB. There are some ratings below BBB, such as CCC, however, bonds with ratings below BBB would be considered too risky for an inexperienced investor. These ratings are assigned to what are commonly referred to as "junk bonds" (see Table 6-1).

Table 6-1
Bond Ratings Using Standard & Poor's and Moody's Rating Codes (These rating systems are similar, although not identical)

S&P's	Moody's	Meaning	Comment
AAA	Aaa	Best quality, smallest degree	These four ratings are given

		of investment risk; issuers are exceptionally stable and dependable.	to “investment bonds.
AA	Aa	High quality by all standards; slightly higher degree of long-term investment risk.	
A	A	Many favorable investment attributes	
BBB	Baa	medium grade quality; adequate at present but may be unreliable over the long term.	
BB	Ba	Have speculative element; moderate security of payments; not well safeguarded.	Bonds with these ratings are commonly referred to as “junk” bonds.
B	B	Not considered to be a desirable investment; little long-term assurance of payments.	
CCC	Caa	Poor standing; issuers in danger of default or may already be in default	
CC	Ca	Highly speculative; often in default	
C	C	Lowest rate class bonds; very poor prospects of ever attaining	

“investment
grade” basis.

D. In default.

Sources: Sumner N. Levine. ed. *The Financial Analysis Handbook* (1988), pp. 1102–1112; Richard Saul Wurman, Alan Siegel, and Kenneth M. Morris, *The Wall Street Journal: Guide to Understanding Markets and Money* (1989).

While credit-rating services are valuable to investors who do not have access to professional staffs for evaluating bonds, such services should be viewed simply as one of many sources that investors should use. An investment in bonds should not depend solely on the basis of credit ratings. In many instances, credit ratings lag behind current developments, and as a result, credit-rating services do not always downgrade a firm’s ratings quickly enough to save investors from big losses. An investment-grade rating on a corporate bond can deteriorate instantaneously, because of a sudden takeover, leveraged buy-out (LBO), or corporate restructuring.

Another guide to safety when you are considering buying corporate bonds is whether the bond agreement contains a provision for establishing a *sinking fund*. A provision for a sinking fund requires the issuing corporation to set aside an annual reserve of cash from its earnings to insure there is enough money to redeem or repay the principal for the bonds at maturity. In return for this added safety, you, the bondholder, must be willing to settle for a lower yield that you would get on a bond without a sinking fund.

You can buy corporate bonds through your banker or securities broker. Depending on the issuing corporation and your relationship with the bank or brokerage firm, the transaction fee may be between \$10 to \$20 per \$1,000 bond.

JUNK BONDS

“Junk bonds” are a much-publicized category of corporate bonds because of their role in recent corporate takeovers and their purported role in the failure of several large financial institutions. These bonds are characterized by their relatively high yields and relatively low ratings. Because the major rating agencies regard these bonds as speculative, and therefore more risky than investment-grade bonds, the high yields are intended to compensate investors for the extra risk in holding such bonds.

Indeed the record shows that default rates on low-grade bonds have been much higher than those on high-grade bonds, lending credibility to the relatively low ratings given to junk bonds by the major rating agencies. A study by New York University Professor Edward I. Altman found that between 1970 and 1988, the average annual default rate for junk bonds was about 2.4 percent of total

dollar value, while the default rate for investment-grade debt was close to zero percent (see Table 6–2). In a study released in 1989, Moody’s Investors Service, Inc. found that an average of 3.3 percent of junk-bond issuers defaulted each year between 1970 and 1988. That compares to an annual default rate of 0.06 percent for issuers of investment-grade bonds. The most recent study, one made in 1989, indicated that the default rate for junk bonds since 1980 was about 11.2 percent of those issued, as compared with only 1.0 percent for investment-grade bonds. This study concluded that junk bonds accounted for more than two-thirds corporate bond issues that have defaulted since 1980.

To be sure, all junk bonds are not alike, and increasingly there are more pronounced “tiers” of quality appearing on the market. As a result, junk bonds are finding their share of investors, particularly pension funds, insurance companies, bank trust departments, and mutual funds. Perhaps these investors—to some extent—are counting on the fact that default bonds do not become worthless, but retain, on average, about 40 percent of their face value.

Table 6–2
High Yield Bond Default Calculations, 1977–1988

Year	Altman Default	Loss to	First Boston
	rate^a	Investors^b	Loss to Investors^c
1977	4.49%	NC	3.64%
1978	1.27	NC	0.99
1979	0.19	NC	0.21
1980	1.48	NC	1.07
1981	0.16	NC	0.76
1982	3.12	2.05%	3.62
1983	1.07	0.54	0.55
1984	0.83	0.46	0.50
1985	1.68	1.02	1.55
1986	3.39	2.40	2.64
1987	5.12 ^d	1.65	1.88
1988	NC	NC	1.33
Average rate	2.07 ^e	1.35	1.63 ^f

Notes = NC = Not calculated

^a Default rate calculated by dividing the par value of the defaulting high yield bond by the par value of high yield bond outstanding.

^b Dr. Altman’s calculations account for residual value of defaulted bonds to determine actual loss.

^c First Boston’s default rate calculations used market value of bonds as opposed to par value to determine actual loss.

^d Rate would have been about 1 percent without Texaco Inc. and affiliates

default of \$1,345 billion. Virtually all of these bonds were originally issued as investment grade.

^e Rate would have been 1.69 percent without Texaco.

^f Rate would have been 1.15 percent without Texaco and other "fallen angel" defaults.

Source: United States General Accounting Office, *High Yield Bonds: Issues Concerning Thrift Investments in High Yield Bonds*, March 1989, p. 19.

Guidelines for an Individual Investor

In many ways, the performance of junk bonds tends to resemble that of stocks, which lose value during an economic downturn. The reason for this similarity stems from the belief by investors and credit rating services that an economic downturn will depress the earnings of corporations and reduce their cash flow, making it difficult for debt-laden companies to meet their obligations. In contrast, Treasury securities increase in value during an economic downturn because their prices rise when there is a decline in interest rates, which usually fall when the economy is weakening.

Although individual investors are still not the primary market for junk bonds, some underwriters are issuing such bonds in denominations of \$1,000 in an effort to broaden the overall market for such bonds. If such a development expands, each investor ought to review his or her own investment objectives and current portfolio for guidance on whether to buy such bonds. If you are a very sophisticated investor, have the flexibility in your portfolio to take some high risks in search of high yields, and are prepared to conduct extensive research on the firms issuing the junk bonds, then you might give some thought to purchasing junk bonds. After all, an investor in a coupon-paying junk bond may receive enough periodic interest payments to recoup his or her investment even if the junk bond issuing company goes bankrupt. For instance, a buyer of a 16 percent bond would have gotten back almost the entire face value of the bond after six years, not counting reinvestment income.

Assuming that you fit into the category of investors described in the above paragraph, it may be well for you to consider the following advice:

1. *Junk Bond Mutual Funds.* Invest in junk bond mutual funds because they offer individual investors the opportunity to own part of a diversified portfolio, in some instances, for as little as a few hundred dollars. In addition to diversity, these mutual funds offer professional management and research.

2. *Diversity.* If you feel that your judgement is as good as that of a professional manager in choosing junk bonds, then you should make sure that you achieve diversity in order to spread the risks. As a minimum you should select from ten separate issues of junk bonds,

and from at least three different industries.

3. *Publicly listed.* Confine your purchases to junk bonds listed on a stock exchange. Because these bonds are traded on stock exchanges, they can be tracked easily, thus giving you an advantage in case things don't go well. Another advantage is the fact that the price quotes for these bonds are published in many newspapers on a daily basis.

4. *Covenants.* Look for issuing companies that offer bonds with *covenants*. These are essentially the provisions written into a bond prospectus that protects investors. Although protective covenants are not very common nowadays and frequently are difficult to understand when they are offered, you might try to focus on such key words as *dividend test*, *net worth test*, *merger* or *sale test*. A dividend test supposedly stops the company from paying dividends on its stock or buying stock back, thus keeping money in the company. A net worth test usually requires that the company agrees to maintain a certain net worth. If the net worth drops below that level, the company agrees to buy back a certain percentage of its bonds. A merger or sale test prevents a company from selling all its assets and leaving a shell corporation holding its debts.

In addition to the foregoing, you might be well advised to consider two other guidelines when considering a purchase of junk bonds. First, avoid bonds that are part of issues under \$50 million. These can be very illiquid. Second, be selective about the yields. Lower yields do not compensate you for the risk you are taking. Extremely high yields, on the other hand, may indicate a company that is in serious trouble. Third, the default and settlement rate of corporate bonds, in general, suggest that investors in junk bonds should require a premium of as much as 7 percentage points over U. S. Treasury securities to compensate for the greater risk on junk bonds.

IMPORTANT NUMBERS ON BONDS

Usually, the most prominent number on a bond is a figure called the principal or the par value. For some buyers or investors, this figure is also the price. This figure, however, is not necessarily the price that all investors pay for the bond. One investor can sell a bond to another investor for a price less than the figure shown as the value. When this happens, it is said that the bond "sold at a discount." When the bond is sold for a price higher than the par value, it is said that the bond is "sold at a premium." To determine the price of a bond in newspaper quotations, simply move the decimal place of the quoted price one place to the right. Thus, for a bond whose par value is \$1,000, a quoted price of "100" usually means a price of \$ 1,000. A quoted price of say \$104 1/2" means a price of \$1,045. The prices of

both bond and market interest rates change frequently. When they change, they usually go in opposite directions. Thus, when market interest rates rise, the price of a bond will fall because a potential buyer of the bond will want a yield that is in line with market interest rates, as against the lower interest rate stipulated on the bond itself. By the same token, if market interest rates fall, the price on the bond will rise because the seller of the bond will want a price that compensates the higher yield that is given up when it is sold to someone else.

In addition to the current yield of bonds, investors should work with other measures of return on bonds such as the following:

1. *Yield to Maturity*. This measure of a bond's return gives consideration to both interest payments and price change resulting from the difference between the purchase price of the bond and its par value. This measure also assumes a reinvestment process with a reinvestment rate equal to yield-to-maturity rate.

illiquid: difficult to sell in case you need cash immediately.

If the bonds are subject to final payment at a time other than the stated maturity, or at a price other than par value, a yield calculation should include the foregoing factors if the probability of their occurrence is high.

2. *After-tax Yield*. This measure used for comparing alternative investments in which income taxation is a crucial factor. Applicable tax rates must be used for both ordinary income and capital gains, which are now taxed as ordinary income.

3. *Compound or Realized Yield*. This measure recognizes interest payments, purchase price, reinvestment rates, final payment price, actual maturity, and tax rates in determining the investor's return from an investment in bonds. While the computation of yield does require an investor's subjective inputs, this analysis provides the investor with a framework for testing the sensitivity of a bond return to these inputs and for comparing investments in financial instruments on an equal basis.

Yield To Maturity (YTM)

The YTM on a bond should be very important to investors because it allows them to compare an investment in bonds with alternative investments. The exact YTM can be found in bond tables at large libraries and in brokers' offices. However, investors can also calculate the YTM on a particular bond using this formula:

$$I + \left(\frac{FV - CV}{N} \right)$$

$$YTM = \frac{\left(\frac{FV + CV}{2} \right)}{\left(\frac{FV + CV}{2} \right)}$$

where

- I = interest paid annually in dollars
- FV = face or par value of the bond
- CV = current value or market price of the bond
- N = number of years until maturity

For example, if Sidney Wasson paid \$940 for a \$1000 face value, 20-year, 8 percent stated rate (coupon rate) bond, the YTM would be approximately 8.5 percent.

$$YTM = \frac{\$80 + \frac{(\$1,000 - \$940)}{20}}{\frac{(\$1,000 + \$940)}{2}}$$

$$= \frac{\$83}{970}$$

$$= 8.55\%$$

“GINNIE MAES”

Among the specialty types of bond, those referred to as *Ginnie Maes* provide one of the better sources for generating cash for the investor. Ginnie Maes are actually certificates issued by the Government National Mortgage Association, which buys FHA and VA insured mortgages from private lenders, such as, commercial banks, savings and loan associations, and mortgage bankers. Buyers of Ginnie Mae certificates are actually investing in one of these pools of mortgages, and as an owner of mortgages, the investor’s earnings come in the form of interest. The monthly payment that the investor receives includes the return of a portion of the mortgage principal, along with the interest.

Investors should be aware of the fact that, with the receipt of each monthly check, the mortgage portion is actually a return of part of the investor's original investment. This means that the investor has the responsibility of reinvesting these funds as soon as possible to ensure the stability of his or her investment program. The payment statement that accompanies the monthly check details the portion that is interest earnings and the portion that represents a return of principal.

For investors who like to compare Ginnie Maes with United States Treasury bills, notes and bonds, the following should be noted:

. . . United States Treasury Bills, notes and bonds are direct obligations of the Federal Government. Ginnie Maes have only a generalized guarantee by the Federal Government.

. . . Interest earnings from United States notes and bonds are subject to federal taxation, but are exempt from state and local taxation. Earnings from Ginnie Maes are subject to federal, state, and local taxation.

. . . Minimum amounts for investment in the United States Treasury securities are \$10,000 for bills, \$5,000 and \$1,000 for bonds. The minimum investment for a Ginnie Mae certificate is \$25,000.

BACKING OF FEDERAL AGENCY SECURITIES

Whether the bonds issued by GNMA and FNMA are backed by the full faith and credit of the federal government is really academic. All of the securities issued by these two agencies are excellent credit risks, because it is highly doubtful that the federal government would allow the debts of one of its agencies go into default.

RISK WITH BONDS

In general, bonds issued by corporations are good investments for generating immediate cash as long as the investor buys bonds of investment grade. The ratings of bonds by the major rating agencies are always available to the public, and investors would be wise to consider these ratings along with some personal research on the issuing corporation before making a final decision.

Notwithstanding favorable ratings of bonds by the rating agencies and person research, there remain some risks when investing in corporate risks. These risks may be outlined as follows:

A Bankrupt Issuer. Perhaps the most dreaded risk is that the issuer may go bankrupt before the bonds mature. If and when this happens, the bond holders, like other creditors, will have to take their places in line for any payment from the proceeds of the issuer's assets. The bond holders' places in line depend in part upon the security behind the bonds. Some bonds may be subordinated, that is, have a claim on the assets of the corporation only after most other claims are satisfied;

while other bonds may be secured by specific real assets, making such bonds similar to a mortgage. These kinds of details are spelled out in the listing of terms under which the bonds are issued called the indenture.

Missed Interest Payments. A second risk is that a financially-troubled issuer may skip interest payments along the way, although interest payments are still payable if the issuer ever overcomes its cash flow problem.

Change in Interest Rates. A third risk referred to as the change-in-interest-rate risk. If interest rates rise after the bond is issued, the value of the bond declines. For example, if the investor buys a bond with a face value of \$1,000 and a 10 percent coupon, the investor would receive \$900 annually in interest earnings. Now, if market interest rises to 11 percent, later purchasers of the bonds will not be satisfied with getting just a \$100 return on a \$1,000 investment. They will want \$110. The rate on most bonds is fixed, however, thus as they rise, the resale value of the bond declines. In this example, the new investor would still get \$100 in interest earnings, but would have to invest only \$909. The rise in market interest rates, therefore, would have meant that the original purchaser had lost \$91 on the sale of the bond.

Callable Bonds. A fourth major risk is that the bonds will be called by the issuer. Calling a bond is simply redeeming it before the maturity date provided in the indenture. This is a risk because when a bond is called there may not be a comparable investment paying as high a yield as the one that the investor is forced to give up. Many bonds are called when interest rates are declining below the rate on the outstanding issues. Thus, when the bond is called, investors will be forced to reinvest their funds at lower rates. One distinct advantage of U. S. Treasury bonds is that they have excellent call protection.

Indexing. One of the suggested ways of reducing some of the risks associated with bonds, particularly with regard to changes in price and interest rates, is adopted indexing. Indexing involves buying a selected group of bonds whose performance tracks some market gauge. A growing number of professional managers are resorting to bond indexing, and there are a growing number of bond indexes calculated by reputable brokerage and securities firms. Individual investors who desire to invest in bonds via this particular route can buy shares in an indexed mutual fund offered by a reputable fund.

In some respects, investing in an indexed mutual fund for bonds may cost the individual investor less than placing them with an investment management firm. The difference in costs may be due to

the mechanical nature of bond indexing, as against the need for highly paid analysts and investment strategists to make frequent changes in a bond portfolio.

Like just about everything else, indexing has its critics. Some analysts contend that although indexing may work well in rising markets, active management of the bond portfolio is needed to avoid trouble when bond prices are falling. Other analysts contend that good professional managers can beat bond indexes by carefully studying credit risks, sector analysis, and Federal Reserve monetary policy.

BONDS AS INVESTMENT

Like other financial assets, bonds as an investment have a variety of features, all of which can have an impact on the investor's ultimate objectives. For example, corporate bonds are an excellent investment for individual retirement accounts (IRA's), Keoghs, pensions, and other tax-sheltered arrangements. All interest earned in these retirement accounts is tax-deferred, thus the growth rate is dramatically higher.

The risks associated with bonds may be smaller or larger than those associated with buying stocks. In the case of stocks, the price can go up or down and there is no way to predict what the price will be at any date in the future. Also, companies can decide to increase, decrease, or eliminate dividends altogether without violating any contract with stockholders. If an investor plans to hold a bond to maturity, and the issuer does not go bankrupt, the investor knows exactly how much money he or she will get back at a certain date in the future. The investors also know how much interest they will receive while they hold the bonds, if the issuer is able to pay it. Perhaps for these reasons and others, Andrew Mellon, former Secretary of Treasury, once said, "Gentlemen prefer bonds."

CHAPTER 7

THE BEST GAME IN TOWN: INVESTING IN TREASURIES

Calls Your Attention To:

- . . . Buying these securities without paying any fees or charges
- . . . Minimum Investments of \$1,000
- . . . Receiving Your Interest Earnings Twice a Year
- . . . How to Buy These Securities by Mail
- . . . How to Forecast Yields on Treasuries
- . . . How to Sell Treasury Securities
- . . . The Many Advantages of Buying Treasuries

CHAPTER 7

THE BEST GAME IN TOWN: INVESTING IN TREASURIES

What makes investing in Treasury securities (often referred to as “treasuries”) the best game in town? Well, at least ten things. **First**, for the past several years, the average yield on these securities has been competitive with those on all other securities. **Second**, the interest earnings can be expected on schedule, without any exception. **Third**, these securities are backed by the full faith and credit of the Federal Government. **Fourth**, although the interest earnings on these securities are taxable by the Federal Government, the earnings are exempt from income taxes levied by state and local governments. **Fifth**, an investor can buy most Treasury notes and bonds for as little as \$1,000. **Sixth**, investors can avoid any fee or commission, by purchasing the Treasury securities directly from Federal Reserve Banks, their branches, or the Bureau of Public Debt in Washington, D. C. **Seventh**, interest earnings are deposited directly into the investor’s personal account, whether at a local commercial bank or savings institution. **Eighth**, in an emergency, investors can always sell their Treasury securities through their local banks. **Ninth**, if an investor needs a loan, he or she will find Treasury securities are the best collateral in the entire world. **Tenth**, Treasury securities can be purchased by mail directly from any of the 12 Federal Reserve Banks, their branches and the Bureau of Public Debt in Washington, D. C.

PURCHASING TREASURIES

There are three categories of Treasury securities, namely bills, notes, and bonds. Bills have maturities of thirteen, twenty-six, and fifty-two weeks. Notes have maturities of more than one year and not more than ten years. The more popular notes have maturities of two, three, four, five-year-two months, and ten years. Bonds have maturities in excess of ten years. Analysts often refer to the thirty-year bond as the bellwether of long-term bonds in the nation’s financial markets.

Original Sale

All Treasury securities are sold originally through an auction process held at Federal Reserve banks. The 13 and 26-week Treasury bills are sold every Monday. The general pattern of Treasury note and bond sales may be found in Exhibit 7-1. For specific dates and times within this pattern, the investor should telephone a Federal Reserve Bank. Two kinds of bids are accepted, competitive and noncompetitive. Competitive bids are usually submitted by large institutional investors. They specify the price that they are willing to pay for the securities. Individual investors usually submit noncompetitive bids. By submitting this kind of bid, the investor is not required to state a price or yield that he or she will pay. Instead, the investor agrees to accept the weighted-average yield and price established in the auction and indicates the amount of securities that he or she wishes to purchase. This assures individual investors that their bids will be accepted within certain limitations if the bids are below specified dollar amounts. Treasury securities are marketable securities. This means that after their original issue as just described, they may be bought or sold in the secondary (commercial) market at prevailing market prices through financial institutions, brokers, and dealers.

Purchase Procedure

When buying Treasury securities directly from a Federal Reserve Bank or the Bureau of Public Debt, the investor must complete a form known as a *Tender*. A sample Tender form is shown as Exhibit 7-2 in order for the investor to know the kind of information that he or she must have before arriving at the bank for the purchase. The minimum purchase for Treasury bills is \$10,000; the minimum for Treasury notes ranges from \$1,000 to \$5,000 depending on the maturity; and the minimum for bonds is \$1,000. Payment must be made when submitting a Tender. This payment may be made in cash; by personal check (certified for Treasury bills); by check issued by the traditional depository institutions (provided such checks are drawn to the order of a specific Federal Reserve Bank or the Bureau of Public Debt); with redemption checks issued by the Bureau of Public Debt in payment of matured Treasury securities, provided the Tender is submitted in the name(s) of the payee(s); with matured U. S. Treasury securities, or with checks drawn on money market or mutual fund accounts.

Exhibit 7-1 General Pattern of Treasury Note and Bond Financing by Month

The following is the current pattern of financing for marketable Treasury notes and bonds. The events are listed in the order in which they normally occur. Treasury borrowing requirements, financing policy decisions, and the timing of Congressional action on the debt limit could alter or delay the pattern. This outline is provided solely for reference and is not intended to convey information about any particular Treasury security offering. The Treasury Department issues a press release announcing each offering. Current information on specific upcoming Treasury auctions may be obtained from a Federal Reserve bank or branch, from the Bureau of the Public Debt, U.S. Department of the Treasury, or from the financial press.

January: Announce 2-year note
 Auction 2-year note
 Announce 3-year and 10-year notes, and 30-year bond
 Issue 2-year note

February: Auction 3-year note
 Auction 10-year note
 Auction 30-year bond
 Announce 2-year note
 Issue 3-year and 10-year notes, and 30-year bond
 Announce 5-year + 2-month note
 Auction 2-year note
 Auction 5-year + 2-month note
 Issue 2-year note

March: Issue 5-year + 2-month note
 Announce 2-year, and 4-year notes
 Auction 2-year note
 Auction 4-year note
 Issue 2-year and 4-year notes

April: Announce 2-year note
 Auction 2-year note
 Announce 3-year and 10-year notes
 Issue 2-year note

May: Auction 3-year note
 Auction 10-year note
 Announce 2-year note
 Issue 3-year and 10-year notes,
 Announce 5-year + 2-month note
 Auction 2-year note
 Auction 5-year + 2-month note
 Issue 2-year note

June:	Issue 5-year + 2-month note Announce 2-year, and 4-year notes Auction 2-year note Auction 4-year note Issue 2-year and 4-year notes
July:	Announce 2-year note Auction 2-year note Announce 3-year and 10-year notes, and 30-year bond Issue 2-year note
August:	Auction 3-year note Auction 10-year note Auction 30-year bond Announce 2-year note Issue 3-year and 10-year notes, and 30-year bond Announce 5-year + 2-month note Auction 2-year note Auction 5-year + 2-month note Issue 2-year note
September:	Issue 5-year + 2-month note Announce 2-year, and 4-year notes Auction 2-year note Auction 4-year note Issue 2-year and 4-year notes
October:	Announce 2-year note Auction 2-year note Announce 3-year and 10-year notes Issue 2-year note
November:	Auction 3-year note Auction 10-year note Announce 2-year note Issue 3-year and 10-year notes Announce 5-year + 2-month note Auction 2-year note Auction 5-year + 2-month note Issue 2-year note
December:	Issue 5-year + 2-month note Announce 2-year, and 4-year notes Auction 2-year note Auction 4-year note Issue 2-year and 4-year notes

Exhibit 7-2 Tender for Treasury Bond

TREASURY
DIRECT

TENDER FOR TREASURY BOND

TENDER INFORMATION		FOR DEPARTMENT USE
AMOUNT OF TENDER: \$ _____		TENDER NUMBER 912810
TERM _____		
BID TYPE (Check One) ☐ NONCOMPETITIVE ☐ COMPETITIVE AT _____ %		
ACCOUNT NUMBER _____		
INVESTOR INFORMATION		CUSIP _____ ISSUE DATE _____ RECEIVED BY _____ DATE RECEIVED _____
ACCOUNT NAME _____		EXT REG ☐ FOREIGN ☐ BACKUP ☐ REVIEW ☐

CITY _____ STATE _____ ZIP CODE _____		
TAXPAYER IDENTIFICATION NUMBER		CLASS ☐
1ST NAMED OWNER _____ OR _____ SOCIAL SECURITY NUMBER _____ EMPLOYER IDENTIFICATION NUMBER _____		
TELEPHONE NUMBERS		
WORK (____) _____ HOME (____) _____		
PAYMENT ATTACHED		NUMBERS
TOTAL PAYMENT: \$ _____		
CASH (01): \$ _____ CHECKS (02/03): \$ _____ SECURITIES (05): \$ _____ OTHER (06): \$ _____		
DIRECT DEPOSIT INFORMATION ROUTING NUMBER _____ FINANCIAL INSTITUTION NAME _____ ACCOUNT NUMBER _____ ACCOUNT NAME _____		
AUTHORIZATION		ACCOUNT TYPE ☐ CHECKING (Check One) ☐ SAVINGS
For the notice required under the Privacy and Paperwork Reduction Act, see the accompanying instructions. I submit this tender pursuant to the provisions of Department of the Treasury Circular, Public Debt Series Nos. 1-86 and 2-86 and the public announcement issued by the Department of the Treasury. Under penalties of perjury, I certify that the number shown on this form is my correct taxpayer identification number and that I am not subject to backup withholding because (1) I have not been notified that I am subject to backup withholding as a result of a failure to report all income or dividends, or (2) the Internal Revenue Service has notified me that I am no longer subject to backup withholding. I further certify that all other information provided on this form is true, correct, and complete.		
SIGNATURE _____		DATE _____

*U.S. GPO: 1988-210-953

Before going to a Federal Reserve Bank or the Bureau of Public Debt, the investor should have the appropriate information for completing the tender. Among this information are the following:

1. The investor's Treasury Direct account number.
2. The name of the local financial institution where the investor wishes to receive all direct deposits.
3. The routing number of the financial institution named in #2.
4. The investor's account number in the financial institution named in #2.

All checks must be made payable to a specific Federal Reserve Bank or Branch to which the Tender is submitted. Checks submitted to

the Bureau of Public Debt must be made payable to that agency. Checks that are submitted to that agency, but made payable to a Federal Reserve Bank are not acceptable, and any such check sent to that agency will cause the Tender to be rejected.

In addition to buying Treasury securities at Federal Reserve Banks, investors may buy them by mail. When they are purchased by mail for the first time, the investor should obtain and complete a W-9 form. This form may be obtained from an office of the Internal Revenue Service or from a commercial bank. This form should then be submitted with a subscription letter (typed or carefully printed) and containing the following information:

- a. name and address;
- b. telephone number
- c. amount of securities desired;
- d. whether bid is noncompetitive or competitive
- e. preference for form in which the securities are to be issued, name(s) for registration; along with social security numbers for each name.
- f. direct deposit information: name of the purchaser's financial institution, names on the account, number and type of account (i.e., checking or savings account; and
- g. the purchaser's signature

In addition to supplying the above information, the purchaser should: (1) enclose the proper payment; (2) indicate on the outside of the envelope the following legend, "Tender for Treasury Notes (Bonds);" and (3) mail the letter to a Federal Reserve Bank (or branch) or to the Bureau of the Public Debt, Treasury Department.

OWNERSHIP OF REGISTRATION OPTIONS

Investors in marketable Treasury securities have a wide choice of registration options which are designed to address most investor needs and ownership situations. These options (listed below) have the ability to establish clear ownership and survivorship rights. In addition to these options, registration can be made in the name of estate representatives, trustees, private organizations, as well as governmental officers. If an additional security is deposited in an existing account, the security will be registered in the name and form of registration that appears in the designated Account Master Record.

Registration Options

- ***Single Ownership:*** Registration in the name of an individual. The name should be in the form ordinarily used by the investor

preferable including at least one full given name.

- ***Joint Ownership With Right of Survivorship:*** Registration in the names of two individuals, joined by the word “and,” ending with “right of survivorship.” Transaction requests must be signed by both owners. This form of registration creates a conclusive right of survivorship. Example: Mark A. Doe and Mary B. Doe, with right of survivorship.
- Registration in the name of two individuals, joined by the word “and,” ending with “without right of survivorship.” Transaction requests must be signed by both owners. This form of ownership does not create right of survivorship. The share of the the decedent passes to his or her estate.

Example: Elizabeth Black and Jane Brown, without the right of survivorship.

- ***Co-ownership:*** Registration in the names of two individuals, joined by the word “or.” Transaction requests may be signed by either co-owner. This form of registration creates a conclusive right of survivorship.

Example: Robert Woods or Laura Woods.

- ***Beneficiary:*** Registration in the name of one individual, followed by the words “payable on death to” (“P.O.D.”) another individual. If a minor or an incompetent is named as the beneficiary, the beneficiary’s status must be identified in the registration. Transaction requests may be signed by the owner and do not require the consent of the beneficiary Ownership rights are transferred to the beneficiary only after death of the owner.

Example: Jack S. Jones, payable on death to Marie Jones.

Also, John Perry, P.O.D. John Perry, Jr., a minor.

- ***Natural Guardian:*** Registration in the name of a natural guardian of a minor (a security may not be registered in the name of a minor in his or her own right). Transaction requests are signed by the guardian on the behalf of the minor until the disqualification of the natural guardian, the qualification of legal guardian or similar representative, or the minor’s attainment of majority.
- ***Custodian:*** Registration under an applicable gifts to minors statute. Any request to alter the ownership rights must be made as provided in the applicable statute.

Example: Virginia McDonald, as custodian for Lynne Gorman, under the New York Uniform Gifts to Minors Act.

INTEREST EARNINGS

Interest earned on Treasury securities is exempt from state and

local income taxes. However, the interest is subject to the Federal income tax. For specific Federal income tax liability, the investor should consult the Internal Revenue Code.

Because Treasury securities are sold at auction, investors do not know the coupon interest rate or the investment yield on these securities at the time of purchase. These factors are usually reported in the major newspapers on the day following the auction, and by mail to the investors several days later.

Notes and Bonds

Treasury notes and bonds carry a fixed interest coupon rate. When this rate is communicated to the investor by mail, he or she can apply this rate to the par value of the security in order to arrive at the annual interest earnings. Depending on the actual price of the note or bond set by the Treasury at the auction, the investor's annual interest earnings may amount to an investment yield that is greater or less than the coupon interest rate. If the actual price at auction is set below the par value, the securities are sold at *discount*, and thus the investment yield will be greater than the coupon interest rate. On the other hand, if the auction price is set above the par value, the securities are sold *at premium*, and thus the investment yield will be less than the coupon interest rate. (See Exhibit 7-3) The interest earnings are payable by direct deposit into the investor's bank account every six months.

Whether the securities are sold at discount or at premium is determined by the average price or investment yield submitted as competitive bids by mostly financial institutions, such as banks and brokerage firms. Their bids, in turn, are influenced by market factors and alternative investments. These bids specify the investment yield or price that these firms are willing to accept. The final auction price or investment yield is the weighted average of these bids, which noncompetitive bids have already agreed to accept. In the end, the Treasury will accept or fill the order of all noncompetitive bids. It will then accept competitive bids, beginning with the lowest yield, through successively higher yields to the level of funds that the Treasury had planned to borrow from the public.

SALE OF TREASURY NOTES AND BONDS

Currently, all Treasury notes and bonds are book-entry securities evidenced as accounting entries in the records of the U. S. Treasury Department, a Federal Reserve Bank or a financial depository institution. TREASURY DIRECT is the name commonly used to refer to the Book-entry Securities System in which investors' accounts of book-entry Treasury marketable securities are maintained on the record of the Bureau of the Public Debt, U.S. Treasury Department in

Washington, D. C. Engraved certificates are no longer issued to purchasers of Treasury notes and bonds.

There are occasions when the payment for the notes or bonds must include the principal amount or par value of the securities and the accrued interest on the securities from the date of the last scheduled interest payment to the effective date of purchase of these securities. Notice of this additional part of the payment usually appears on the front page of the tender in fairly bold type. The amount of this additional payment is always expressed as an amount per \$1,000 of the securities purchased, along with the precise period of time for which the interest has accrued. The amount of this accrued interest will be included in the investor's next scheduled interest payment.

Also occasionally, under the terms of the official Treasury offering circular, the period from the rate of issue to the first interest payment date may be more or less than six months. When this occurs, the first interest payment will be an amount that is larger or smaller than the remaining payments. All subsequent interest payments to the investor will be computed on a six-month basis and will be one-half of the dollar amount to be paid annually under the terms of the offering.

TREASURY DIRECT PROVIDES THE INVESTOR WITH A PORTFOLIO OF TREASURY SECURITIES

Whenever an investor purchases marketable Treasury securities, TREASURY DIRECT sends him or her a Statement of Account, which includes the price of all previously purchased securities. The date and amount of the next interest payment and the total amount of securities held in the investor's TREASURY DIRECT Account.¹

Bills

Treasury bills do not bear a stated interest rate. An investor's earnings may be calculated by taking the difference between the price paid for the bills and the amount the purchaser receives for them, which is either:

1. The face value of the bills if they are held to maturity; or
2. The market value of the bills if they are sold before maturity.

The difference between what is actually paid for the bills and the face value of the bills—assuming the bills are held until maturity—is formally called a discount. For example, if the purchase price of a 13-week Treasury bill is \$9,857.90, the discount is \$142.10 because the par value is always \$10,000. The \$142.10 would be sent to the investor immediately as a *refund* and not *prepaid interest*. The

investor's actual interest income would come three or six months later, when the Treasury bill actually matures and the investor receives the full par value amount of \$10,000.

The results of the auction of Treasury bills are reported in the Tuesday edition of most major newspapers. The yields on 13 and 26-week bills are usually reported on both a discount rate and an annual investment yield or "return" basis. Because the investor's money is invested for less than a year on these bills, the annual investment yield is always greater than the discount rate yield, and enables the investor to compare the return on this investment with that on other investments.

In the example cited above, the newspaper announcement would not mention the \$142.00 in interest earnings. The announcement, however, would cite the discount rate of 5.62 percent, which the investor could use to calculate the \$142.00 in interest earnings immediately by using the following formula.

Step 1: Discount rate x the par value of the bill

Step 2: Results of

$$\text{Step 1} \times \frac{\text{No. of Days to Maturity}^*}{360} = \text{interest earnings}$$

Using the information above, the interest earnings would be computed as follows:

$$5.62 \text{ percent} \times 10,000 = 562$$

$$562 \times 0.2528 = \$142.10$$

*Use 91 days for 13-week bill and 182 days for 26-week bill.

TO SELL OR PLEDGE TREASURY SECURITIES

Like investors in other financial instruments, owners of Treasury securities may want to sell their securities before they mature for reasons of emergency or economic reasons such as the specter of inflation which would reduce the value of their securities. Or, these owners may want to pledge their securities for a loan. Either of these two actions can be accommodated very easily through TREASURY DIRECT, a name commonly used to refer to the book-entry securities system in which investors' accounts of Treasury marketable securities are maintained on the records of the Bureau of Public Debt, U. S. Treasury Department. Investors desirous of selling or pledging their Treasury securities should take the following steps:

1. Contact a commercial bank to see whether it is willing to sell or take possession of your securities. If it agrees to do so, inform them that you are transferring your securities to its account.
2. Obtain Form PD 5179, entitled Security Transfer Requests from a Federal

Reserve Bank, in person or by mail. To complete this form, you, the investor will need to know the name Routing number of the bank that will sell the securities. Your signature on this form authorizes the transfer of all or part of your securities to that particular bank.

3. Mail or take the completed Form PD 5179 to a Federal Reserve Bank so that your request can be entered into the commercial book-entry system. The form should be received not later than 20 days before interest payment date or the maturity of the security.

After these steps are taken, the Federal Reserve Bank will process Form P D 5179 and have your securities transferred to the commercial bank. Shortly, thereafter, the bank will contact you on the sale of your securities or the completion of the pledging transaction.

HOW TO FORECAST RATES ON TREASURY SECURITIES

Unlike a bank certificate of deposit, corporate bond, or municipal bond, the purchaser of Treasury securities will not know the rate of interest to be earned on a Treasury bill, note, or bond before the purchase is made. While some observers may regard this as a disadvantage of investing in Treasury securities, the problem is not that difficult to overcome. Almost every daily newspaper has a financial section that contains columns entitled, "Quotations on Treasury Issues or (Government Securities)." These tables show the most recent market interest rates for various Treasury securities, and experience shows that these rates are not likely to change dramatically within the next twenty-four hours or even the next two or three days.

If investors would like to narrow the range of their forecast of an interest rate on a forthcoming issue of 30-year (actually 29 + years) of Treasury bonds, they could wait until the morning of the auction to consult the quotations in the morning newspaper. For example, for the 30-year Treasury bonds to be auctioned on Thursday, May 7, 1992, investors in Richmond, Virginia could review the columns under "Treasury Issues" in that morning's edition of the *Richmond Times-Dispatch*. (See Exhibit 7-4) They should look under the three columns with the headings of "Mat," "date," and "Yld." In these columns they should look specifically for November under the column, "Mat" and 2021 under the "date." Then, if they read across to the right, they will see 7.96 under the column "Yld." This figure should be a good forecast of the interest rate on the bonds to be issued. The investors would then have until 12:00 noon on the day of the auction to submit their tender to the Federal Reserve Bank of Richmond. The results of the auction as reported in the next day's newspaper is 7.96 as shown in Exhibit 7-4.

Exhibit 7-3 Formulas for Yields on Notes and Bonds

Instead of borrowing funds for a year or less, the Treasury may decide to obtain funds for a longer period by selling notes or bonds. These securities pay the investor a fixed annual return or *coupon* (which is paid twice a year) in addition to the face or par value, if held to maturity.

Treasury notes and bonds may be sold either at a discount or at a premium. When sold at a discount, the investor pays less than face value. For example, a newly issued bond or note with a purchase price of \$95 means the investor receives a discount of \$5 per \$100 of face value. A security with a face value of \$1,000, then, would cost \$950.

When a bond or note is sold by the Treasury at a premium, the investor pays a price greater than face value. For example, if the purchase price of a new bond or note were \$110, the investor would pay \$1,100 for each \$1,000 of par or face value.

The actual price paid—whether a discount or a premium—determines the true rate of return or investment yield on the note or bond, as it does on any other financial investment. If the security is purchased at a premium or at a discount, the return will be different from the fixed annual coupon rate the investor is legally entitled to receive.

The following formulas may be used to calculate the approximate annualized investment yield of a bond or note if held to maturity:

- a. investment yield if the security is bought at a *discount*:

$$R = \frac{\text{annual total value of the coupon rate} + \left[\frac{\text{amount of the discount}}{\text{number of years to maturity}} \right]}{\frac{\text{security par or face value} + \text{purchase price}}{2}}$$

- b. investment yield if the security is bought at a *premium*:

$$R = \frac{\text{annual total value of the coupon rate} - \left[\frac{\text{amount of the discount}}{\text{number of years to maturity}} \right]}{\frac{\text{security par or face value} + \text{purchase price}}{2}}$$

Note: The difference between the two is that the discount formula takes a *plus* sign while the premium formula has a *minus* sign in the numerator.

Example

Suppose the Treasury auctions a two-year note which has a coupon rate of 8½% of the par or face value. The coupon is payable semi-annually. (The annual total dollar value of the coupon is \$8.50 per \$100 of par value; semi-annual payments are one-half of the coupon or \$4.25 per \$100 of par value.) Also, assume that the original purchase price of this note is \$99.802 per \$100 par value, i.e., there is a discount of \$0.198 per \$100 (\$100 - \$99.802). What is the investment yield? To find it, use the discount formula:

$$\begin{aligned}
 R &= \frac{\$8.50 + \left[\frac{\$0.198}{2} \right]}{\frac{\$100 + \$99.802}{2}} \\
 &= \frac{\$8.50 + \$0.099}{\$99.901} \\
 &= \frac{\$8.599}{\$99.901} \\
 &= .0861 \text{ or } 8.61\%
 \end{aligned}$$

If the number of years to maturity is stated in years and months, e.g., four years and one month, convert the month into a fraction of a year. In other words, one month is 1/12 of a year—or, in its decimal equivalent, 0.0833 years. Four years and one month, then, can be written as 4.0833 years.

Problem

What is the investment yield of a 20-year, 1-month treasury bond issued at a price of \$99.407 and with an annual coupon of 11.75%, payable semi-annually?

Answer

$$\begin{aligned}
 R &= \frac{11.75 + \left[\frac{\$0.593}{20.0833} \right]}{\frac{\$100 + \$99.407}{2}} \\
 &= \frac{11.75 + 0.02953}{99.7035} \\
 &= \frac{11.77953}{99.7035} \\
 &= .1181 \text{ or } 11.81\%
 \end{aligned}$$

In the preceding discussion on notes and bonds, the investment yield was calculated on the assumption that an investor purchased a newly issued security and held it until maturity. Such a purchase is done in the *primary* securities market. Rather than holding a security to maturity, an investor may decide to sell it to another investor. This is done in the *secondary* securities marketplace. The foregoing formulas can be adapted to evaluate the investment yield of government securities traded in secondary markets, but that step does not go to the basics of interest rate calculation. For additional information, consult published bond value handbooks.

Source: Richard D. C. Trainer, *The Arithmetic of Interest Rates*, Federal Reserve Bank of New York, 1984, pp. 19-21.

Exhibit 7-4 Treasury Issues

Treasury issues

NEW YORK (AP) — Over-the-Counter U.S. Treasury bonds and issues to investors bid and asked prices in dollars. 13-weeks. Subject to Federal Reserve Bank of New York's bid and asked prices.			NEW YORK (AP) — Over-the-Counter U.S. Treasury bonds and issues to investors bid and asked prices in dollars. 13-weeks. Subject to Federal Reserve Bank of New York's bid and asked prices.		
1993	1994	1995	1993	1994	1995
6.75 Nov 1993	104-54 104-12	104-54 104-12	6.75 Nov 1993	104-54 104-12	104-54 104-12
6.83 Nov 1993	104-54 104-12	104-54 104-12	6.83 Nov 1993	104-54 104-12	104-54 104-12
11.75 Nov 1993	110-20 110-24	110-20 110-24	11.75 Nov 1993	110-20 110-24	110-20 110-24
5.50 Dec 1993	106-11 106-15	106-11 106-15	5.50 Dec 1993	106-11 106-15	106-11 106-15
5.00 Dec 1993	105-06 105-10	105-06 105-10	5.00 Dec 1993	105-06 105-10	105-06 105-10
2.63 Dec 1993	104-21 104-25	104-21 104-25	2.63 Dec 1993	104-21 104-25	104-21 104-25
7.00 Jan 1994	102-58 102-62	102-58 102-62	7.00 Jan 1994	102-58 102-62	102-58 102-62
4.80 Jan 1994	101-75 101-79	101-75 101-79	4.80 Jan 1994	101-75 101-79	101-75 101-79
5.00 Feb 1994	102-58 102-62	102-58 102-62	5.00 Feb 1994	102-58 102-62	102-58 102-62
5.80 Feb 1994	103-40 103-44	103-40 103-44	5.80 Feb 1994	103-40 103-44	103-40 103-44
6.80 Feb 1994	104-11 104-15	104-11 104-15	6.80 Feb 1994	104-11 104-15	104-11 104-15
7.80 Feb 1994	104-26 104-30	104-26 104-30	7.80 Feb 1994	104-26 104-30	104-26 104-30
8.80 Feb 1994	104-41 104-45	104-41 104-45	8.80 Feb 1994	104-41 104-45	104-41 104-45
9.80 Feb 1994	104-56 104-60	104-56 104-60	9.80 Feb 1994	104-56 104-60	104-56 104-60
10.80 Feb 1994	104-71 104-75	104-71 104-75	10.80 Feb 1994	104-71 104-75	104-71 104-75
11.80 Feb 1994	104-86 104-90	104-86 104-90	11.80 Feb 1994	104-86 104-90	104-86 104-90
12.80 Feb 1994	104-101 104-105	104-101 104-105	12.80 Feb 1994	104-101 104-105	104-101 104-105
13.80 Feb 1994	104-116 104-120	104-116 104-120	13.80 Feb 1994	104-116 104-120	104-116 104-120
14.80 Feb 1994	104-131 104-135	104-131 104-135	14.80 Feb 1994	104-131 104-135	104-131 104-135
15.80 Feb 1994	104-146 104-150	104-146 104-150	15.80 Feb 1994	104-146 104-150	104-146 104-150
16.80 Feb 1994	104-161 104-165	104-161 104-165	16.80 Feb 1994	104-161 104-165	104-161 104-165
17.80 Feb 1994	104-176 104-180	104-176 104-180	17.80 Feb 1994	104-176 104-180	104-176 104-180
18.80 Feb 1994	104-191 104-195	104-191 104-195	18.80 Feb 1994	104-191 104-195	104-191 104-195
19.80 Feb 1994	104-206 104-210	104-206 104-210	19.80 Feb 1994	104-206 104-210	104-206 104-210
20.80 Feb 1994	104-221 104-225	104-221 104-225	20.80 Feb 1994	104-221 104-225	104-221 104-225
21.80 Feb 1994	104-236 104-240	104-236 104-240	21.80 Feb 1994	104-236 104-240	104-236 104-240
22.80 Feb 1994	104-251 104-255	104-251 104-255	22.80 Feb 1994	104-251 104-255	104-251 104-255
23.80 Feb 1994	104-266 104-270	104-266 104-270	23.80 Feb 1994	104-266 104-270	104-266 104-270
24.80 Feb 1994	104-281 104-285	104-281 104-285	24.80 Feb 1994	104-281 104-285	104-281 104-285
25.80 Feb 1994	104-296 104-300	104-296 104-300	25.80 Feb 1994	104-296 104-300	104-296 104-300
26.80 Feb 1994	104-311 104-315	104-311 104-315	26.80 Feb 1994	104-311 104-315	104-311 104-315
27.80 Feb 1994	104-326 104-330	104-326 104-330	27.80 Feb 1994	104-326 104-330	104-326 104-330
28.80 Feb 1994	104-341 104-345	104-341 104-345	28.80 Feb 1994	104-341 104-345	104-341 104-345
29.80 Feb 1994	104-356 104-360	104-356 104-360	29.80 Feb 1994	104-356 104-360	104-356 104-360
30.80 Feb 1994	104-371 104-375	104-371 104-375	30.80 Feb 1994	104-371 104-375	104-371 104-375
31.80 Feb 1994	104-386 104-390	104-386 104-390	31.80 Feb 1994	104-386 104-390	104-386 104-390
32.80 Feb 1994	104-401 104-405	104-401 104-405	32.80 Feb 1994	104-401 104-405	104-401 104-405
33.80 Feb 1994	104-416 104-420	104-416 104-420	33.80 Feb 1994	104-416 104-420	104-416 104-420
34.80 Feb 1994	104-431 104-435	104-431 104-435	34.80 Feb 1994	104-431 104-435	104-431 104-435
35.80 Feb 1994	104-446 104-450	104-446 104-450	35.80 Feb 1994	104-446 104-450	104-446 104-450
36.80 Feb 1994	104-461 104-465	104-461 104-465	36.80 Feb 1994	104-461 104-465	104-461 104-465
37.80 Feb 1994	104-476 104-480	104-476 104-480	37.80 Feb 1994	104-476 104-480	104-476 104-480
38.80 Feb 1994	104-491 104-495	104-491 104-495	38.80 Feb 1994	104-491 104-495	104-491 104-495
39.80 Feb 1994	104-506 104-510	104-506 104-510	39.80 Feb 1994	104-506 104-510	104-506 104-510
40.80 Feb 1994	104-521 104-525	104-521 104-525	40.80 Feb 1994	104-521 104-525	104-521 104-525
41.80 Feb 1994	104-536 104-540	104-536 104-540	41.80 Feb 1994	104-536 104-540	104-536 104-540
42.80 Feb 1994	104-551 104-555	104-551 104-555	42.80 Feb 1994	104-551 104-555	104-551 104-555
43.80 Feb 1994	104-566 104-570	104-566 104-570	43.80 Feb 1994	104-566 104-570	104-566 104-570
44.80 Feb 1994	104-581 104-585	104-581 104-585	44.80 Feb 1994	104-581 104-585	104-581 104-585
45.80 Feb 1994	104-596 104-600	104-596 104-600	45.80 Feb 1994	104-596 104-600	104-596 104-600
46.80 Feb 1994	104-611 104-615	104-611 104-615	46.80 Feb 1994	104-611 104-615	104-611 104-615
47.80 Feb 1994	104-626 104-630	104-626 104-630	47.80 Feb 1994	104-626 104-630	104-626 104-630
48.80 Feb 1994	104-641 104-645	104-641 104-645	48.80 Feb 1994	104-641 104-645	104-641 104-645
49.80 Feb 1994	104-656 104-660	104-656 104-660	49.80 Feb 1994	104-656 104-660	104-656 104-660
50.80 Feb 1994	104-671 104-675	104-671 104-675	50.80 Feb 1994	104-671 104-675	104-671 104-675
51.80 Feb 1994	104-686 104-690	104-686 104-690	51.80 Feb 1994	104-686 104-690	104-686 104-690
52.80 Feb 1994	104-701 104-705	104-701 104-705	52.80 Feb 1994	104-701 104-705	104-701 104-705
53.80 Feb 1994	104-716 104-720	104-716 104-720	53.80 Feb 1994	104-716 104-720	104-716 104-720
54.80 Feb 1994	104-731 104-735	104-731 104-735	54.80 Feb 1994	104-731 104-735	104-731 104-735
55.80 Feb 1994	104-746 104-750	104-746 104-750	55.80 Feb 1994	104-746 104-750	104-746 104-750
56.80 Feb 1994	104-761 104-765	104-761 104-765	56.80 Feb 1994	104-761 104-765	104-761 104-765
57.80 Feb 1994	104-776 104-780	104-776 104-780	57.80 Feb 1994	104-776 104-780	104-776 104-780
58.80 Feb 1994	104-791 104-795	104-791 104-795	58.80 Feb 1994	104-791 104-795	104-791 104-795
59.80 Feb 1994	104-806 104-810	104-806 104-810	59.80 Feb 1994	104-806 104-810	104-806 104-810
60.80 Feb 1994	104-821 104-825	104-821 104-825	60.80 Feb 1994	104-821 104-825	104-821 104-825
61.80 Feb 1994	104-836 104-840	104-836 104-840	61.80 Feb 1994	104-836 104-840	104-836 104-840
62.80 Feb 1994	104-851 104-855	104-851 104-855	62.80 Feb 1994	104-851 104-855	104-851 104-855
63.80 Feb 1994	104-866 104-870	104-866 104-870	63.80 Feb 1994	104-866 104-870	104-866 104-870
64.80 Feb 1994	104-881 104-885	104-881 104-885	64.80 Feb 1994	104-881 104-885	104-881 104-885
65.80 Feb 1994	104-896 104-900	104-896 104-900	65.80 Feb 1994	104-896 104-900	104-896 104-900
66.80 Feb 1994	104-911 104-915	104-911 104-915	66.80 Feb 1994	104-911 104-915	104-911 104-915
67.80 Feb 1994	104-926 104-930	104-926 104-930	67.80 Feb 1994	104-926 104-930	104-926 104-930
68.80 Feb 1994	104-941 104-945	104-941 104-945	68.80 Feb 1994	104-941 104-945	104-941 104-945
69.80 Feb 1994	104-956 104-960	104-956 104-960	69.80 Feb 1994	104-956 104-960	104-956 104-960
70.80 Feb 1994	104-971 104-975	104-971 104-975	70.80 Feb 1994	104-971 104-975	104-971 104-975
71.80 Feb 1994	104-986 104-990	104-986 104-990	71.80 Feb 1994	104-986 104-990	104-986 104-990
72.80 Feb 1994	104-1001 104-1005	104-1001 104-1005	72.80 Feb 1994	104-1001 104-1005	104-1001 104-1005
73.80 Feb 1994	104-1016 104-1020	104-1016 104-1020	73.80 Feb 1994	104-1016 104-1020	104-1016 104-1020
74.80 Feb 1994	104-1031 104-1035	104-1031 104-1035	74.80 Feb 1994	104-1031 104-1035	104-1031 104-1035
75.80 Feb 1994	104-1046 104-1050	104-1046 104-1050	75.80 Feb 1994	104-1046 104-1050	104-1046 104-1050
76.80 Feb 1994	104-1061 104-1065	104-1061 104-1065	76.80 Feb 1994	104-1061 104-1065	104-1061 104-1065
77.80 Feb 1994	104-1076 104-1080	104-1076 104-1080	77.80 Feb 1994	104-1076 104-1080	104-1076 104-1080
78.80 Feb 1994	104-1091 104-1095	104-1091 104-1095	78.80 Feb 1994	104-1091 104-1095	104-1091 104-1095
79.80 Feb 1994	104-1106 104-1110	104-1106 104-1110	79.80 Feb 1994	104-1106 104-1110	104-1106 104-1110
80.80 Feb 1994	104-1121 104-1125	104-1121 104-1125	80.80 Feb 1994	104-1121 104-1125	104-1121 104-1125
81.80 Feb 1994	104-1136 104-1140	104-1136 104-1140	81.80 Feb 1994	104-1136 104-1140	104-1136 104-1140
82.80 Feb 1994	104-1151 104-1155	104-1151 104-1155	82.80 Feb 1994	104-1151 104-1155	104-1151 104-1155
83.80 Feb 1994	104-1166 104-1170	104-1166 104-1170	83.80 Feb 1994	104-1166 104-1170	104-1166 104-1170
84.80 Feb 1994	104-1181 104-1185	104-1181 104-1185	84.80 Feb 1994	104-1181 104-1185	104-1181 104-1185
85.80 Feb 1994	104-1196 104-1200	104-1196 104-1200	85.80 Feb 1994	104-1196 104-1200	104-1196 104-1200
86.80 Feb 1994	104-1211 104-1215	104-1211 104-1215	86.80 Feb 1994	104-1211 104-1215	104-1211 104-1215
87.80 Feb 1994	104-1226 104-1230	104-1226 104-1230	87.80 Feb 1994	104-1226 104-1230	104-1226 104-1230
88.80 Feb 1994	104-1241 104-1245	104-1241 104-1245	88.80 Feb 1994	104-1241 104-1245	104-1241 104-1245
89.80 Feb 1994	104-1256 104-1260	104-1256 104-1260	89.80 Feb 1994	104-1256 104-1260	104-1256 104-1260
90.80 Feb 1994	104-1271 104-1275	104-1271 104-1275	90.80 Feb 1994	104-1271 104-1275	104-1271 104-1275
91.80 Feb 1994	104-1286 104-1290	104-1286 104-1290	91.80 Feb 1994	104-1286 104-1290	104-1286 104-1290
92.80 Feb 1994	104-1301 104-1305	104-1301 104-1305	92.80 Feb 1994	104-1301 104-1305	104-1301 104-1305
93.80 Feb 1994	104-1316 104-1320	104-1316 104-1320	93.80 Feb 1994	104-1316 104-1320	104-1316 104-1320
94.80 Feb 1994	104-1331 104-1335	104-1331 104-1335	94.80 Feb 1994	104-1331 104-1335	104-1331 104-1335
95.80 Feb 1994	104-1346 104-1350	104-1346 104-1350	95.80 Feb 1994	104-1346 104-1350	104-1346 104-1350

Source: U.S. Treasury Dept. www.fedreserve.gov www.fedreserve.gov www.fedreserve.gov www.fedreserve.gov www.fedreserve.gov www.fedreserve.gov www.fedreserve.gov www.fedreserve.gov www.fedreserve.gov

to narrow the forecast of interest rates as much as investors who can buy the securities in person at a Federal Reserve Bank (or branch). Noncompetitive tenders submitted by mail must be postmarked no later than midnight the day prior to the auction and must be received no later than the date of the issue.

TREASURY SECURITIES AND FINANCIAL GOALS

Treasury securities have a place in every investor's portfolio. Rich or poor, old or young, married or single, family with children or family with no children, one or more of the advantages for investing in Treasury securities, as enumerated at the beginning of this chapter, is that they can be used to realize the fulfillment of the investor's financial goals. The existence of one of these sets of personal circumstances, however, along with the consideration of such factors as the state of the economy, outlook for the investor's employment, and the investor's current portfolio should influence the priority given to these advantages.

As pointed out in Chapter 3, investing in Treasury securities is suited for persons who are novices in investing and who want to keep their investing activity as simple as possible. Investors who are not interested in trading securities; who have other funds for emergencies; who either do desire or have the inclination to monitor their investments on a daily basis; and who do not want to be bothered with frequent communications from brokers, can simply buy these securities and wait on their interest earnings to be paid twice a year. Even when the investor does not reside in the immediate proximity of a Federal Reserve Bank, one of its branches, or the Bureau of Public Debt, purchasing Treasury securities by mail can become routine and prove to be as simple as visiting the local commercial bank.

When most investors compute the tax equivalency of their government securities, they are considering only their securities issued by state, local governments and agencies of these governments because these securities are exempt from federal, state, and local income taxes when the investor is a resident of the state issuing the securities. However, few of these investors compute the tax equivalency of Treasury securities, which are exempt from state and local income taxes. The exemption from income taxes at these two levels of government should loom large in the investor's decision to buy Treasury securities, not only because of the magnitude of these two categories of taxes in some areas, but also because these particular taxes have increased significantly more than federal income taxes during the past several years.

Footnote

[1](#)In 1995, the Treasury implemented an annual account maintenance fee of \$25 for each Treasury DIRECT account exceeding \$100,000 in total holdings.

CHAPTER 8

ABSOLUTELY FREE MONEY: INVESTING IN TAX-EXEMPT SECURITIES

Provides Information On:

- ... Tax advantage of investments in these securities
- ... How to compute equivalent taxable yield
- ... Buying bonds directly
- ... “Housings” as tax free bonds
- ... Who invests in tax free bonds

CHAPTER 8

ABSOLUTELY FREE MONEY: INVESTING IN TAX-EXEMPT SECURITIES

As a term, “tax-exempt securities” refers to bonds issued by state and local governments and their agencies. Tax-exempt is used interchangeably with the term “tax-free” because the interest earnings on these bonds are exempt from federal income taxes, and state and local income taxes, if the investor or buyer lives in the same state in which the bonds are issued. (Some bonds issued after August 7, 1986 may be subject to federal taxation.) These bonds are commonly referred to as “munis,” and they may be purchased individually, through municipal bond funds, or through unit trusts. When purchased individually municipal bonds pay fixed semi-annual interest to the investor, and the principal is refunded upon maturity.

Municipal bonds can be a source of regular, fixed and predictable income. They can help investors control their tax liability, and they are fairly liquid. If interest rates go up, the market value of the bonds goes down. On the other hand, if interest rates go down, the market value of the bonds would increase. If the investor holds the bonds until maturity, the principal or face value of the bonds will be returned in full.

TYPES OF MUNICIPAL BONDS

Most municipal bonds are issued by state and local governments, as well as agencies created by these governments. The bonds are issued to obtain funds for such purposes as construction, repair, or improvement of public facilities, including schools, streets, highways, bridges, and water and sewer works. There are three basic types of municipal bonds, with each type having a number of variations.

The General Obligation Bond

This type of municipal bond is secured by the pledge of the full faith, credit, and taxing power of the issuing authority. Because of this

pledge, general obligation bonds are considered safer and therefore carry lower rates of interest or yields than the other types. When the rating agencies evaluate general obligation bonds, they take into consideration such factors as the tax base, population, total debt outstanding, other statistics, along with the area's general economic climate.

The Revenue Bond

When this type of bond is issued, the interest and return of the principal are payable from the revenue derived from the project for which the bond funds are used to finance. The revenue usually takes the form of tolls, charges, or rents paid by the users of the facility or project. Because these bonds do not have the full taxing power of a governmental unit behind them, they are not considered as safe as general obligation bonds, and therefore carry higher interest rates and yields.

Before buying revenue bonds, the investor ought to scrutinize the project very carefully because it is difficult to generalize about the relative safety of various revenue bonds. The yields on these bonds can be very enticing; but investors with modest resources should rarely invest in such bonds.

The Special Group

Prominent among special group bonds are "housings," which are issued by, and are the direct obligation of, local housing authorities. The bonds are issued under the provision of the Federal Housing Act of 1949. Although each issue is secured by a pledge of the net rental revenues of a local housing project, the Public Housing Administration agrees to make annual payments to the fiscal agent of each bond issue, in an amount sufficient to meet the estimated annual debt service for a period of up to forty years, regardless of the physical or financial standing for the local housing project. This applies, however, only to multiple family public housing.

Because "housings" are issued by, and are the direct obligation of, local housing authorities or agencies, and because these authorities build public housing for low-income tenants, most investors view the bonds as straight revenue bonds. These investors usually think of public housing bonds as a very risky investment because many people have a negative view of low-income families' sense of responsibility about paying rent.

Public housing bonds, though, are not risky investments. Such bonds are issued under the provision of the Federal Housing Act of 1949. And, although each issue is secured by a pledge of the net rental

revenues of a local housing project, the Public Housing Administration agrees to make annual payments to the fiscal agent of each bond issue, in an amount sufficient to meet the estimated annual **debt service** for a period of up to forty years, regardless of the physical or financial standing of the local housing project. This applies, however, only to multiple family public housing.

Thus for all intents and purposes, public housing bonds are backed by the federal government, and they have the added advantage of being exempt from federal, state, and local income taxes (in the state where the authority is located). In addition to these advantages, public housing bonds generally contain adequate **call protection** for investors, and they are often available in \$1,000 denominations.

Another bond in this special group is the “special-tax bond,” so-named because it is payable from the proceeds of a special tax, such as a gasoline tax. The bond is also referred to as a “pledge bond” since the tax proceeds are pledged toward the payment of interest and principal of the bond, a further variation is the *special-assessment* bond, which is payable only from assessments against those properties that benefit from the facility resulting from the sale of the bonds.

TAX ADVANTAGE AND EQUIVALENT TAX YIELD

No doubt the main attraction of municipals as investments is the tax advantage for the investor. However, the investor should not invest in these securities simply because the interest earnings are tax-exempt. You can calculate how much taxable interest it would take to match a given rate of tax-exempt interest by using the formula that follows. To do this, you need to know the marginal tax rates applied to your taxable income on federal, state, and local returns. If you don’t know them, you should check the rate schedules on each return for the highest percentage rate at which your income is taxed. Remember to use taxable income in the formula, not gross income.

In the formal sense, you should really compute the *equivalent taxable yield* when comparing an investment in tax-free securities with an investment in other securities. Also, you should make the computations yourself because many of the statistics on this topic that appear in advertisements ignore the impact of state income taxes. For a simple formula in making your computations, you can use the following:

Tax-exempt yield / (1 minus tax rate) = equivalent taxable yield

debt service: interest requirements plus stipulated payments of principal on outstanding debt.

call protection: the specific period of time during which a callable securities issue cannot be recalled.

For example, suppose you are offered a bond with a 6 percent tax-free yield. You are in the top federal bracket of 33 percent, and, to take the worst case scenario, you live in the District and are in the 9.5 percent bracket there. What taxable rate would you have to get to match that 6 percent?

First, since local taxes are deductible from federal ones, the rates don't simply add up (assuming you itemize deductions). So you need to figure the *effective* local tax rate.

The formula for that is as follows:

$$\text{Local bracket} \times (1 \text{ minus federal tax rate}) = \text{effective tax rate}$$

Consequently, $9.5 \times (1 \text{ minus } 0.33) = 6.36$. Thus, your overall tax bracket is 39.36—the 33 percent federal rate plus the 6.36 effective local rate. Round this off to 39 for simplicity.

Then subtract 0.39 from 1 and you get 0.61. Divide that 0.61 into 6 and you get 9.8. That is the percentage yield you have to get in a taxable investment to match the 6 percent tax-free yield in that bracket. If you were in the 15 percent federal bracket and lived in a state with no income tax, the yield would be 6 divided by 0.85, which is 7.06.

SAFETY

History shows that fewer than 1 percent of the municipal bonds issued since the Great Depression have gone into default, and the great majority of these have been revenue bonds issued to finance such projects as bridges, turnpikes, utilities, and power plants. This means that general obligation bonds are the safest of the municipal bonds and should be regarded as a sound investment for investors who want a steady income from their savings, without the fear of losing their savings. General obligation bonds are rated by the various rating agencies on the basis of the credit worthiness of the issuing government or agency.

While the “full faith credit, and tax power” behind general obligation bonds make them the safest of municipal bonds, the lack of these features does not mean that all revenue bonds are unsafe. As a matter of fact, revenue bonds issued by certain state-created authorities and agencies are just as safe as the state's general obligation bonds. In many instances these revenue bonds are issued because the state legislature does not want to go through a constitutional process like a statewide referendum to create debt. In such cases, the state-created authority, which technically is not the state government, is authorized to issue bonds, with the understanding that the legislature will appropriate sufficient revenue to meet the bond payments.

Another factor to keep in mind when discussing the safety of revenue bonds is the assumption that no issuer of bonds wants its credit rating or reputation, in general, tarnished by a default on its debt obligations. State agencies created to issue college dormitory bonds, for instance, realize that a default would imperil not only future bond issues, but would also impact unfavorably on the reputation of all of the state's colleges and universities. When considering the purchase of revenue bonds, investors should scrutinize closely the project or enterprise to be financed with the bonds, consult the ratings given to the bonds and remember the rule that suggests that "the higher the stated yield, the greater the risk."

One way of increasing the safety of municipal bonds is to buy those bonds that carry insurance. When bonds are insured, the investor is paid by the insuring firm in case the issuer defaults on the bonds. Insured municipal bonds carry the highest rating, which is triple-A; however, the yield on such bonds is usually lower than that on other bonds.

In 1989, the Securities and Exchange Commission approved formal disclosures rules for municipal bonds that provided prospective buyers of these bonds some of the same protection accorded previously to prospective buyers of corporate bonds. The new rules grew out of the agency's five-year investigation of the \$2.25 billion bond default by the Washington Public Power Supply System, the largest bond default in municipal bond history. These rules require brokerage firms underwriting municipal bond issues exceeding \$1 million in value to obtain extensive information about the projects being financed, the government agencies issuing the bonds, and any foreseeable risks. The bond underwriters then must release this information to all potential buyers in the form of official statements during a certain time period after the bonds are issued.

It may be important to note that prospective buyers of municipal bonds did enjoy some protection with regard to information on the issuance of these bonds before 1989. The anti-fraud regulations of the SEC statute enacted in 1934 barred bond dealers from providing misleading information to the prospective buyers of these bonds.

BUYING BONDS DIRECTLY

There are two principal ways of investing in municipal bonds. One way is through the purchase of shares in a municipal bond fund. This method will be discussed in Chapter 10. The other way is for the investor to buy the actual bonds from a broker/dealer; a depository institution, such as a commercial bank; or through subscription for the issuing agency itself. Most of the bonds are issued in minimum denominations or with a face value of \$5,000, although some are

issued occasionally for \$1,000.

Buying bonds directly imposes a great deal of responsibility on the investor. Both the bonds and the issuing agency should be thoroughly researched. This would include reading the prospectus very carefully, reviewing the grade given by the major rating agencies, and consulting with your local banker, financial advisor, or acquaintances with experience in buying municipal bonds. In buying municipal bonds directly instead of indirectly through the purchase of share in a mutual fund, the investor saves the cost of the various management fees charged by the fund. In both cases, however, the investor is likely to pay a broker's fee.

At one time, an investor had the choice of buying and owning municipal bonds in *registered form* or *bearer form*. In registered form, the owner's name appears on the bond certificate, as well as the records of the trustee and paying agent. The interest payment is then sent to that person until the trustee and paying agent are notified of a change in ownership. In bearer form, the bond certificate is accompanied by a number of individual postage stamp-like coupons. Each coupon contains the amount of the interest payment, date of the payment, and name of the paying agent. The possessor of the coupon presents the coupon to the paying agent to get the interest payment. No record exists to show the name of the bondholder or person receiving the interest payment. In other words, whoever "bears" the bond owns it. In the early 1980's, Congress eliminated the issuing of bearer bonds to prevent holders of these bonds from evading income taxes on the interest earnings.

Those investors who are looking for additional current income and a safe investment should buy only general obligation bonds that are rated Triple-A by the major rating organizations. For consideration of any bonds, general obligation or revenue, with less than a Triple-A rating, investors should insist on at least investment-grade bonds and bonds that are insured. Insured bonds usually have a lower yield than uninsured bonds. In case the issuer defaults, however, the investors would recoup their investment from the insurer.

STILL ALIVE AS A TAX SHELTER

Tax-free or tax-exempt securities are one of the few so-called tax shelters still available to individual investors. For those investors who cherish safety but still want a type of tax shelter, general obligation bonds should be favored over revenue bonds as a tax-free security. Both general obligation bonds and Treasury securities offer maximum safety and a certain amount of tax relief, but only the former is classified as tax-free. Since investors should look at the after-tax return in choosing investments, an investment in tax free securities means

that the investor is willing to accept somewhat lower before-tax interest rates on these securities than on Treasury securities of similar maturity.

Although there is still a favorable ring to the term tax-free, the lowering of individual tax brackets in the Tax Reform Act of 1986 has diminished some of the advantage of investing in municipal bonds. The incentive for choosing these bonds over other types of bonds is different, now that the top federal tax bracket is 28 percent. Yet, when state income taxes are put into the picture, municipal bonds as tax-free securities should have a place in the investor's portfolio.

Factors to Remember

As with all other investments, investors should make sure that the purchase of munis is consistent with their objectives and goals. An investment in munis fits best when the investor's objective is to increase current income and to reduce tax liability. If growth is the main goal, munis may not be the best investment, regardless of the investor's tax status.

The impact of fluctuating interest rates is another factor to remember when considering an investment in munis. As interest rates rise, a bond's market value (what it can be sold for) falls. Of course, the opposite takes place when interest rates decline. If, however, the investor holds the bond to maturity, he or she will receive the full principal or face value of the bond. This will hold true even if the bond suffers a credit downgrade by one of the rating organizations prior to the maturity date.

A final factor to remember is the limited market for the resale of municipal bonds, which can affect the liquidity of these bonds. Experience indicates that many municipal bonds have very restricted secondary markets. This pertains especially to relatively small amounts of bonds. Investors who buy bonds of well-known municipalities have a better chance of selling their bonds than bondholders of lesser known bond-issuing authorities. This factor reinforces the advantage of retaining municipal bonds until they mature.

WHO INVESTS IN TAX-FREE BONDS?

NEW YORK(AP) — Imelda Marcos' quest for a benefactor ended yesterday when tobacco heiress Doris Duke agreed to put up the \$5 million needed by the former first lady of the Philippines to secure her bail on racketeering charges.

Miss Duke will post more than \$5 million in municipal bonds as bail for Mrs. Marcos, who is accused along with her husband, former Philippine President Ferdinand E. Marcos, of looting more than \$100 million from their homeland.

Source: *Richmond-Times Dispatch*, October 17, 1988.

CHAPTER 9

MUTUAL FUND I: TRUSTING YOUR INVESTMENT TO OTHERS

Look for Answers to these Questions:

- . . . What is a mutual fund?
- . . . What are the advantages of a mutual fund?
- . . . How safe are mutual funds?
- . . . What are the important factors in choosing a mutual fund?
- . . . What's the best way to evaluate mutual funds?
- . . . How does one invest in a mutual fund?
- . . . What are the problems and disadvantages of mutual funds?

CHAPTER 9

MUTUAL FUNDS I: TRUSTING YOUR INVESTING TO OTHERS

With your investment experience, you are no doubt familiar with the term, “mutual funds.” What you may not be sure about, is whether you as an investor should put any of your savings in a mutual fund. You are unsure because you are not familiar with the kinds of mutual funds, the safety of your money in mutual funds, the kind of yield that you can expect on your investment, and how you can get your money out of a mutual fund in case you have an emergency that requires money immediately.

First of all, a mutual fund is a collection of various securities or financial instruments purchased for investors by an open-end investment company and managed by professionals in that company. The company is referred to as an open-end company because it will sell new shares in the fund whenever there is a request. These companies are distinguished from closed-end companies in which there is a set number of shares to be sold and left outstanding. The shares of these closed-end companies are traded on the major exchanges.

When individuals invest in a mutual fund, they are actually buying shares in the fund and not in the investment company. Further, they are not buying the securities directly. The investor’s earnings come in the form of dividends.

TYPES OF FUNDS

There are several ways in which mutual funds may be classified. A most meaningful classification is whether the fund is a load fund or a no-load fund. Another important classification describes the kind of securities that the fund manages. These classifications include stock (or equity) funds, tax-free (or tax-exempt) funds, bond funds, balanced (stock and bond) funds, and agency funds. As you can see, this latter classification describes the kinds of investments that the fund manages. Within each of these kinds of funds, however, there is still another classification that pinpoints the nature, or the specific objective, of the investment that the fund manages. For example, an

investor can choose an **aggressive growth stock fund**, an **income stock fund**, a high-grade corporate bond fund, or a low-grade (junk bond) fund.

LOAD AND NO-LOAD FUNDS, AND FEES

One of the differences between mutual funds is that some charge an up-front fee when they are first purchased, while others do not. Those that charge a fee are referred to as “loads.” Those that do not are referred to as “no-loads.” Between these types are mutual funds that charge a supposedly modest up-front fee. These are known as “low-loads.”

Loads vs. No-Loads

The American Association of Individual Investors takes the position that investors should favor no-loads over load funds as an investment. The organization says that “Funds with loads, on average, consistently under-perform no-load funds when the load is taken in consideration in performance calculations.” Also, one rating firm found that the average mutual fund, including no-loads, gained 77 percent in the 5-year period through 1987; whereas, funds that included front-end sales charges, during the same period, produced gains of 74 percent. If you pay a load or sales commission, the actual return on your investment is less than the published results. The reason is that a fund’s published results are based on changes in net asset value and do not reflect the impact of sales or redemption fees. If you search carefully, you can find plenty of well-run no-load mutual funds that fit your goals. On the other hand, if you choose a load fund, you should make sure that loads are not charged on reinvested dividends. Dividends should be reinvested at net asset value.

REASONS FOR INVESTING IN A FUND

There are a number of sound reasons for investing in a mutual fund, although three of these stand out very clearly. First, the investor does not have to perform all of the research that should be done before selecting an individual stock or bond for his or her portfolio. This pertains particularly to investors who are inexperienced and who lack the time and energy to engage in research. It also pertains to investors who do not reside in an area where sources of information are readily available. Second, investing in a mutual fund provides the investor with an opportunity to own a piece of a number of corporations or to become a creditor of a number of corporations and governmental agencies with a modest investment. In other words, a mutual fund offers a diversity of investments to the investor and

eliminates the risk of having “all the eggs in one basket.” This reason is particularly important during cyclical changes in the economy when some industries may be doing very well, while others are experiencing problems. The third reason is the privilege of investing and then having professionals to monitor and manage the investments. Again, this is an advantage to the new and inexperienced investor, as well as to those investors who do not have the time nor the energy to perform these important functions.

aggressive growth stock fund: a mutual fund in which the portfolio of securities consists mostly of stocks that are expected to appreciate in value in the very near future.

income stock fund: a mutual fund in which the portfolio consists mostly of stocks noted for producing generous dividends.

PRE-INVESTING CONSIDERATIONS

The Investor Objectives

Perhaps the first thing that investors should do before choosing a mutual fund is to review their financial objectives. Remember, financial objectives are atypical, and no single fund can meet the needs of all investors or even the changing needs of the same investor. Among the financial objectives that an investor may have are aggressive growth, growth and income, preservation of capital, maximum current income, liquidity, and tax-sheltered income. These objectives should reflect the use of the investor's planned investment program, age, income, tax status, financial position, and willingness to accept risk. Once these objectives are clear in the investor's mind, other factors can be considered.

Safety

All investors should understand that investment companies are nondepository institutions, and therefore, any money entrusted to them is not insured by an agency of the federal government. Nevertheless there are in the United States today a variety of very reputable investment companies with mutual funds, and their histories show an outstanding record of safety. Mutual funds are required by the Securities and Exchange Commission (SEC) to carry insurance against embezzlement, and many funds carry private insurance against other potential problems. As a part of its recently-developed program for monitoring money market mutual funds, the SEC plans to review all funds once a year, with each review to include an on-site

visit, inspection of financial records, a review of procedures, and meetings with fund managers and other officials. Basically, these SEC reviews are intended to make sure that the funds are complying with their prospectuses and with securities laws.

At one point, a number of mutual funds used the words “guaranteed” or “insured” in their advertising. This brought forth a letter from the SEC ordering the funds to be sure that it is clear that the words apply to the underlying holdings and that there is no implication that the words apply to the fund shares. The letter threatened enforcement action under the Investment Company Act for funds that do not comply with the order.

While it is acknowledged that some funds are safer than others, the differences in safety are not very significant. The SEC, for example, limits money market mutual funds investments to highly-rated securities. Then, there are some funds that limit themselves to the very highest ratings of Standard & Poor’s Corporation and Moody’s Investors Service, Inc. Others accept the second-highest rating. The safest funds are those that invest exclusively in Treasury and government agency securities, which are backed by the U. S. Government.

The Fund’s Earnings Performance

It goes without saying that a mutual fund’s earnings performance is certainly a key factor in choosing whether to invest in a fund. The performance of a mutual fund is reflected in its *total return* to the investor on an annual basis. The total return is the combination of the fund’s income (or dividends) it earns, plus any capital gains or losses the principal value (also called market price changes), plus capital gains paid to investors (shareholders) whenever the fund’s securities are sold (called capital gains distributions). It is important to note that when total return figures are given, it is assumed that all income and capital gains have been reinvested, rather than taken as cash throughout the life of the investment.

Perhaps the best way to evaluate a specific fund’s earnings’ performance is to analyze its net asset value—the fund equivalent of per-share earnings—in the ten year financial table reported in many newspapers and in the investment company’s prospectus. Many investors buy mutual funds based on rankings in various financial publications that show a fund as No. 1 in its category, or tops for a specific time period. A more important measurement is the fund’s earnings’ record over several years and over different market cycles. That history, plus the fund’s payout record, gives a good snapshot of the fund’s performance.

Another method of evaluating a fund’s earnings’ performance is to

measure it against a similar fund's performance or an index of the same investments. For example, if you are considering an equity or stock mutual fund, you can measure its performance by comparing its record with the Standard & Poor's stock index. Many investment companies often include that comparison in their prospectus.

For funds that specialize in corporate bonds, the evaluation is a bit more difficult. The earnings returns of these funds will vary depending on the average maturity of the bonds in the portfolio and whether the fund invests in top-rated, lower-yielding bonds or more speculative, higher-yielding bonds.

Many bond managers, however, rate their performance against Shearson Lehman U. S. government and corporate fund index.

Under recently issued SEC rules, some version of the aforementioned information on performance is required in either the fund's prospectus or its annual report. This required information, however, still fails to give the investor a means of evaluating the performance of some of the more popular funds, such as the balanced fund which is made up of half stocks and half bonds. Also, this information is not required to appear in the fund's sales brochure, the first piece of the fund's materials that some of the investors see.

Service

Because most mutual funds offer free check-writing, active investors may want to look at other services offered by a fund before making a choice. One of the services that is growing in importance is that of switching between funds by telephone. This can be accomplished only when the mutual fund is a member of a **family of funds**. A family of funds is an investment company that manages a growth fund, an income fund, a balanced fund, and many others, and gives the investor the privilege of exchanging shares from one fund to another. The exchange privilege is an advantage when the investor's objectives and goals change. For example, a young household may be interested in a growth fund during the early years, but may need more current income after the children become members of the household. This latter development should prompt an exchange of shares held in a growth fund for shares in an income fund. Thus, a family of funds allows investors to change the focus of their investment strategy quickly and efficiently, thereby saving time and money.

family of funds: a number of mutual funds managed by the same investment company, with each fund specializing in a different kind of security or investment product.

Size and Location

While neither of these factors by itself will likely be crucial to your final choice of a mutual fund, both can affect your earnings. As usual, larger firms have the advantage of economics of scale. Their expense ratio may be lower because their fixed costs are spread over a broader base. Also, they may be better able to absorb losses in case of default by one of the securities, and because of sheer size they can buy a more diversified portfolio, thus providing more income stability than smaller funds. Location of a fund is important to investors who don't want to lose interest on their investment funds while the funds are taking a long trip in the mail. Although some funds permit wire transfers from your bank that adds to the investor's costs.

Expenses

Expenses of a mutual fund, which are usually reflected in charges and fees, are important to the investor because they affect the yield on the investment. For the most part, these expenses are the source of charges that a fund deducts from the return on its investments to meet various costs of operating the fund. The greater the charges are, the smaller are the earnings flowing to the investors.

Although some operating expenses for the fund should be expected, one particular fee, known as the 12b-1 fee, bears watching because it is becoming an every-growing part of funds' expenses. The 12b-1 fee was first allowed by the SEC in 1980 as a special charge to finance such promotional expenses as advertising and sales-incentive brokerage commissions. The assumption was that funds could use these fees to attract more investor which in turn would allow the fund to achieve greater economies of scale and increase the yields on investment. Unfortunately, there is little evidence to show that these results have materialized, thus investors are cautioned to review a fund's 12b-1 fees before making a decision to invest with that fund.

MAKING THE DECISION

No investor should have trouble in finding the names of mutual funds. Your local bank or broker will be eager to provide names of funds and assistance in making the purchase. Close friends and reliable associates are further sources of information. In fact, these latter groups may be your best sources because they can relate their experiences with the various funds. In addition to contacting other people, you can consult a number of published sources of information. The public library is one such source. Others include two publications that regularly measure the performance of mutual funds. These are the *United Mutual Fund Selector*, *Wiesenberger Investment Companies Service*,

The Prospectus

After locating the names and addresses of several mutual funds, the investor should request a prospectus from the funds that he or she decides to consider. Among other things, a prospectus describes the fund's operation and how prospective investors can buy shares in the fund. A prospectus should provide the investor with such information as:

The company's investment objectives, that is, whether it seeks to provide income, protect capital, minimize taxes, etc.;

The amount of any fees or charges;

The procedures for buying and redeeming shares;

When distributions are made and dividends are paid

How long the fund has been in existence and how much experience the investment company has had in managing funds; and

What services the investment company provides.

CAUTION!!!

- In reading the prospectus, be on the lookout for any mentioning of pending lawsuits or regulatory reviews. Mutual funds must disclose any "meaningful" litigation pending against them or any review by a government agency. If something like this is mentioned, you should get in touch with the investment company for details. Even after receiving these details, you should think seriously about investing in the fund.
- Just about every prospectus carries some type of disclaimer. This is usually placed in the section on the fund's investment objective, and it usually emphasizes the basic risk involved. You should read this disclaimer very carefully because it may state that the fund plans to invest in certain risky securities that you might not like.

If there is anything in a prospectus that you do not understand, you should consult someone with expertise in the financial field, such as your local banker. Also, if you are not confident in your ability to evaluate a fund's investments, you should consult one of the rating services. One such service is the Institute for Econometric Research, which publishes *Money Fund Safety Ratings*. This publication uses a letter rating system similar to that for bonds, (i.e. AAA, AA, BB, etc.) and the ratings are based on quality of assets, diversification, average portfolio maturity and **volatility**.

volatility: a measure of the rapidity with which a security changes in value as compared with the market generally.

While it still pays to scrutinize a prospectus very carefully, investors in mutual funds enjoy much more protection from the SEC today than in previous years. This agency now requires mutual funds to present a much clearer picture of their charges and performance. The agency also requires mutual funds to meet stricter guidelines on advertising claims.

Purchasing the Shares

After reviewing very carefully the prospectus from a number of funds and then choosing a fund, you should:

1. complete the purchase application furnished with the prospectus;
2. make a check or money order to the fund in the amount stipulated as the minimum investment; and
3. send the check or money order and the purchase application to the fund at the address stipulated in the prospectus.

Accounts opened in more than one name will be registered as joint tenants with rights of survivorship, unless indicated otherwise. When registering these accounts, the signatures of all joint tenants are required on redemption by mail and change of registration requests.

Remember, when you buy shares in a mutual fund, you are actually buying ownership interests or common stock in the fund. Usually there is no charge or fee for the purchase, and, the minimum investment might be as low as \$500. Each fund's prospectus describes upon receipt of payment and a completed application. Many funds will accept initial subscriptions by telephone.

Generally, additional minimum investments range from \$100 to \$1,000. Many funds will accept such additions by telephone, and some funds will even arrange for additional investments to be made through payroll deduction or from automatic monthly bank drafts drawn against the shareholder's checking account. If for some reason the investor wants to redeem his or her shares, the fund will buy back the shares at their current unit price. This unit price may be more or less than the original price paid by the investor, except for money market funds, shares in a money market mutual fund are always worth \$1.

PROBLEMS AND DISADVANTAGES

There is little question about the advantages that mutual funds hold for certain investors. The convenience, professional management, and diversity of investment offered by mutual funds definitely have

some value. At times, even the yield compared to that of other investments, makes mutual funds a fairly attractive investment. As with other investments, however, mutual funds carry certain disadvantages and pose potential problems that all investors should be aware of before they become too heavily committed on this particular investment.

Earlier in this discussion, the safety record of mutual funds was applauded because only one mutual fund to date has ever gone bankrupt or been forced out of business for any reason. This safety, however, does not extend to a guaranteed return of all the funds originally invested by the buyer of the mutual fund's shares. Like many other investments, shares of mutual funds are affected by changes in interest rates, the operations of the companies and organizations in which the mutual fund has invested, and economic conditions in general. Thus, it is possible for the price of a share in a mutual fund on a given day to be less than the price originally paid by the investor. This, in turn, could result in a loss to the investor who seeks to redeem his shares on that particular day.

Also, as in the case of all other stocks, there is no guaranteed yield or rate of total return on mutual funds, guaranteed yield or rate of total return on mutual funds. The rate of earnings and total return are traditionally affected by the same factors that cause fluctuations in the share price of mutual funds.

Not only is a guaranteed yield lacking on a mutual fund investment, but also the availability of information needed to monitor the yields on a frequent basis. The prospectus sometimes cites the recent history of the fund's yields, but the daily quotations in newspapers are mostly confined to the net asset value (NAV), share price (Price), and the difference between today's net asset value quote and that of the previous day (Chg.). Only periodically do a few of the major newspapers, such as the *Wall Street Journal*, carry quotations that show the yields and total returns for selected periods of time.

CHAPTER 10

MUTUAL FUNDS II: INVESTING IN SPECIAL MARKETS

Expands your general knowledge of mutual funds

- . . . Money market funds
- . . . Stock and bond funds
- . . . Tax-exempt funds
- . . . Ginnie Mae funds
- . . . Government funds
- . . . Futures funds

CHAPTER 10

MUTUAL FUNDS II: INVESTING IN SPECIAL MARKETS

Notwithstanding the fact that most investors in mutual funds are vitally interested in whether the fund produces a significant addition to their current income or a long-term increase in the amount of their investment, all such investors are interested in the kinds of investments that the fund buys and manages to produce these gains. As stated many times earlier, the objective of the investor should be paramount in his or her selection of an investment. In the case of a mutual fund, this factor becomes even more important because investors have such a wide variety of choices from which to seek the fulfillment of their objectives.

FUNDS FOR DIFFERENT OBJECTIVES

Both the number and types of mutual funds have increased enormously over the years as it has become apparent that there are significant advantages in pooling money and having it managed by professionals. Today these funds are highly specialized, and are capable of serving a variety of investment objectives.

MONEY MARKET FUNDS

A money market fund (MMF) is a mutual fund that invests only in money market instruments. These instruments, in turn, are short-term debt securities for which the lending period is a year or less. Typically, these short-term instruments consist of domestic commercial bank CDs, U. S. Treasury bills, and highgrade **commercial paper**. Other short-term instruments might consist of **banker's acceptances**, **Eurodollar** CDs, **repurchase agreements**, and various other U. S. agency issues. (see Table 10–1). Although it takes at least \$100,000 to purchase most money market instruments individually, small savers can make money market investments by buying shares in a money market fund.

commercial paper: short-term, unsecured promissory notes (IOUs) issued by well-known and well-regulated business firms.

As a shareholder, your earnings are dividends distributed from profits made by the investment company. MMFs are designed so that the shares (or net asset value) are always worth \$1. Your dividends come from the interest earned on the money the fund lends to governmental corporation. Because the rates of interest fluctuate every day, you cannot predict how much interest income the fund will earn.

One of the specialty MMFs is the “government-only” money fund. These MMFs invest only in securities issued by the U. S. government and its agencies. Although these are safer than ordinary money funds, there are differences among these government-only funds that affect their relative safety, their yield, and the way income from them is treated for state and local income-tax purposes. Naturally, the funds that invest only in Treasury bills are considered the safest. The next safest are funds that invest in government-agencies, such as those issued by the Government National Mortgage Association (GNMA) and the Federal Home Loan Mortgage Corporation. A fund’s prospectus will state whether it invests in Treasury bills, agency securities, or repurchase agreements. If it is an agency fund, the prospectus will state whether the fund limits itself to certain agencies. Yields on “government-only” funds usually have lower yields than others.

banker’s acceptances: future claims on a bank backed by the bank’s customer; they enable the bank to finance the customer’s business transactions, such as a shipment of goods by a third party.

Eurodollar: deposits denominated in U.S. dollars at banks and other financial institutions outside the United States

repurchase agreements: agreements by a bank or the Federal Reserve to buy back, under certain terms, securities that it originally sold to a second party.

Table 10–1
Composition of MMMF Assets (June 1986, in Billions)

	Amount	% of Total
U.S. Treasury bills	15.4	6.9
Other Treasury securities	6.9	3.1
Other U.S. Treasury bills	14.8	6.7
Repurchase agreements	32.2	14.5
Commercial bank CD ₁	12.7	5.7
Other Domestic CD ₂	4.2	1.9

Eurodollar CD ₃	22.1	10.0
Commercial Paper	98.6	44.4
Bankers' acceptances	10.9	4.9
Other	4.3	1.9
Total assets	222.0	100.0

¹Commercial bank CDs are those issued by American banks located in the United States.

²Other domestic CDs include those issued by S&Ls and American branches of foreign banks.

³Eurodollar CDs are those issued by foreign branches of domestic banks and some issued by Canadian banks; this category includes some one-day paper.

Source: Investment Company Institute.

MMF Offerings

In making your decision to invest in an MMF, you should note whether the fund offers the following:

1. higher interest rates or earnings, compared with some of the traditional investments, particularly passbook savings accounts;
2. no commissions or fees charged when you buy or redeem your MMF shares, as against commissions charged when you buy stocks and bonds through brokers;
3. easy access to your money on request without penalty, as against the penalty for liquidating a consumer-type CD before maturity;
4. limited check writing privileges to third parties;
5. reasonably low minimum deposits and required maintenance balances;
6. flexibility in increasing your investment;
7. a monthly statement showing your earnings for the month, as well as all transactions involving your account during the month;
8. a high degree of safety;
9. professional management;
10. regulation by state and federal laws.

Checkwriting and Withdrawals

Most MMFs have an option that allows shareholders to write checks. In some cases, a minimum amount for each check is stipulated, although competition is gradually causing this stipulation to be dropped. When you write a check on an MMF, you are both withdrawing funds and redeeming some of your shares. Your check to a third party is drawn from an account that the MMF has at a commercial bank. When the check is presented for payment, the bank, as agent for you, as a shareholder, cashes in enough of your shares to cover the check, depositing the money in the MMFs account with the bank. This allows you to continue to earn dividends on the funds while the check is being cleared.

In addition to writing checks, you can, of course, withdraw funds by simply requesting a return of some of your shares. In effect, you would be redeeming some of your shares, and you can do this by the phone or wire request, in which case your money would either be mailed or wired to your bank account. Also, you can close your entire account or redeem all of your shares whenever you so desire. It is possible, however, that the redemption value of your shares may be more or less than the amounts you have invested, depending on the market value of your shares at the time of redemption. Each fund's prospectus should be consulted for specific redemption procedures required by the fund.

Earnings

In its prospectus, an MMF quotes a yield on the prospective shareholder's investment. This yield, however, reflects the prior experience of the MMF and is actually intended only as an indication of the possible yield. MMF managers cannot guarantee the future yield on MMF shares because the yields on money market assets vary over time, and because the yield on MMF shares reflects the level and variability of the yields of the underlying money market assets. Experience shows that the yield for MMPs tend to trail market rate trends. Thus, when short-term market rates are rising, MMF yields will lag; when short-term market rates are declining, MMF yields will fall later.

Yields

In quoting their yields, just about all MMFs use a seven-day yield. Yields on these funds, however, are reported in three ways: 7-day average yield; 30-day average yield, and 12-month average yield. All three are expressed in terms of an average annualized yield. The following is a brief explanation of these three yields:

money market assets: investments in financial instruments, such as, bank certificates of deposit and short-term treasury securities.

The 7-day yield is what the fund would pay over the course of a year if it continued to earn exactly what it earned over the preceding seven days. Because the 7-day average yield measures the most recent performance of money funds, it's the best yield to look at when trying to determine the direction of interest rates.

The 30-day yield is what the fund would pay over the course of a year if it continued to earn exactly what it earned over the preceding 30 days.

The 12-month yield shows what the fund actually paid on average over the past year. Use the 12-month yield when making historical comparisons, such as, comparing how you did in the stock market last year with how well you would have done if your money had been in a money fund.

To arrive at the seven-day yield, the fund first adds the average daily interest accrued to the average daily discount earned per share on the fund's portfolio for that seven-day period, exclusive of gains or losses on portfolio instruments. The fund then subtracts the average daily provision for expenses per share for the seven-day period. This sum, the average net income per share, is then multiplied by 365. The result is the fund's average net yield for that seven-day period stated as though it were on annual yield.

The following illustrates the yield calculation for an MMF for the seven-day period ending April 11, 1987:

Average daily interest accrued (net of premium amortization) and average daily discount earned (including original issue and market discount) per share.	\$.0004096
.	
Less average daily provision for expenses per share.	(\$.000318)
Average daily net income per share.	\$.0003778
Annualized average net yield (average daily net income per share divided by the average daily net asset value (NAV) per share of \$1.00 x 365).	13.79%
.	

The earnings from your investment in a MMF are dividends, and these dividends are generated from interest payments on the various money market instruments after the fund's expenses are deducted. Dividends are usually declared daily, and you may elect to receive these as cash on a regular monthly or quarterly basis or you may have them reinvested in additional shares. Most, if not all, MMFs provide monthly detailed account statements to their shareholders.

Expected Results

Although a fund's past performance cannot guarantee the same results, looking at the 5-year pattern of results shown by the fund you

are considering can prove useful. This record should allow you to determine how well a fund performs in under varying economic environments.

Above all, you should not be persuaded to invest in the latest “hot” fund, “because in so many instances, last year’s spectacular performer will likely be this year’s bust.” Remember, you should not be trying to get rich overnight. Rather, you should be aiming for a consistently reasonable return on your investment with funds inside families of funds that meet your personal investment criteria.

STOCK FUNDS

Those investors who want to invest in corporate stocks, but who know very little about choosing stocks, should give consideration to purchasing shares in a stock (or equity) mutual fund. Investors have a choice of selecting a fund that focuses on stocks noted for producing higher than average income or stocks that are expected to show higher than average growth or capital appreciation. Of course, there are also funds that purchase a mixture of income and growth stocks.

EVALUATING THE FUND’S PERFORMANCE

If you are interested in a stock fund, ask the broker or salesperson to disclose the fund’s total annual return in percentage terms, for each of the past five years (or for the life of the fund, if it is not that old). This information may or may not be in the fund’s prospectus. For comparison, ask the salesperson for the same information on the S&P’s 500 stock average, which is a common measure of market performance by stocks.

Some investment companies offer a variety of stock mutual funds, and permit investors to shift money from one fund to another without paying an additional fee. In effect, the investor would be converting the shares in one particular fund—say an income fund—into a growth fund. The reason for such a shift could be that the investor no longer needs extra current income, but may need more income in the future to supplement his or her pension.

As a result of a regulation passed by the Securities and Exchange Commission in 1992, investors in mutual funds have the same voting rights in the affairs of a corporation as the shareholders of that corporation. This regulation requires banks and brokerage firms to forward proxy materials and other information to their customers for consideration. Investors in mutual funds also have the right to vote on issues governing the fund itself.

In choosing among the variety of stock funds, an investor should review initially his or her current investment objectives. After that,

the investor should continue to update these objectives to make sure that they reflect changes in his or her economic life cycle.

BOND FUNDS

For certain investors, bond mutual funds (or fixed-income funds) carry the same advantages as stock mutual funds. Some bond funds invest only in U.S. government bonds; some invest only in higher-grade corporate bonds; and some specialize in high-yield junk bonds. As with stock mutual funds, the great advantage of bond funds for the small investor is that the risk associated with any particular company's bond is greatly reduced by the size and scope of the fund's portfolio. If, for example, a particular company goes bankrupt, and its bonds become worthless, it could result only in a small loss, as a share of a mutual fund's total holdings.

One significant difference between bond funds and stock funds is that the yields of various stock funds can vary widely, whereas, bond funds with similar investment objectives tend to perform in similar fashion over time. On stock funds, for example, a fortunate pick of a particular stock manager can result in a tremendous yield for that particular fund compared with the yield of competing stock funds. Bond funds, on the other hand—whether government, mortgage, corporate, or municipal—will inevitably yield close to the indexes for the particular type of bond. In other words, there is a limit to what bond fund managers can do to boost the yields of their funds over the others.

Because the underlying performance of bond funds is so similar, the expense ratio and various costs associated with the management of the fund become crucial to the investors' return on their investments. Thus, it is very important for potential investors in bonds to know the total expense of the fund before making an investment in the fund. Information on various costs, including such things as management fees should be provided near the front of the prospectus. These costs are usually listed under the heading, "Annual Expenses," and are generally expressed as an "expense ratio" or percentage of the fund's assets. With this in mind, potential investors in bonds should seek out the fund with the lowest expenses.

TAX-EXEMPT

Tax-exempt funds invest in securities issued by state and local government entities. These funds are so-named because they pay interest income that is exempt from Federal income taxes. These funds are often referred to as municipal bond funds. A small number of tax-exempt funds buy only the securities issued by governments within a

particular state, such as California, Massachusetts or New York. These funds offer investors from those states interest income that is exempt from both Federal and state, and sometimes local income taxes.

Attraction for Investors

Investors in high-income tax brackets may find these funds to be extremely attractive. The returns are somewhat lower than those on funds that specialize in corporate bonds; but this is expected, and investors should review their objectives and economic situations before making a decision to invest in these funds.

For persons contemplating their first investment into the municipals market, the best way to get started is with a tax-exempt mutual fund. These funds buy and sell municipal bonds in response to changing interest rate and credit conditions. Investment in these funds is recommended for persons with \$5,000 or less to invest, because the buy-in price on many funds is as little as \$1,000 and additional shares can be purchased for \$100 each.

If you are shopping for a tax-exempt fund, you should focus on the figure that indicates the total return. This figure combines interest from bonds and profits from bond trading and option selling with the change in market value of the bonds. Another factor to keep in mind while shopping for a bond fund is the management fee. These fees usually range from 0.50 percent to 1.5 percent of your assets in the fund each year. Naturally, you should seek the fund with the lowest management fee.

Tax-exempt mutual funds are appropriate for investors who plan to sell their holdings, perhaps when their children reach college age. Individual bonds, by contrast, are often difficult to unload. Brokers often charge as much as \$20 for every \$1,000 of bonds sold in trades of less than \$25,000. Perhaps it should also be said that while tax-exempt mutual funds simplify the selection process of municipal bonds and spread the investment risk over a diversified portfolio of such bonds, the yields on the funds are often one-half to a full percentage point less than those on individual bonds.

Tax-Exempt vs. Taxable Funds

While tax-exempt funds have obvious advantages for some investors, such advantages are far from being universal. For example, individuals in a low tax bracket might well find that the return on a taxable investment would provide a higher overall yield. Also, since the Tax Reform Act of 1986 lowered the maximum marginal tax rate to 28 percent compared with the previous maximum of 50 percent, even persons in the high income brackets need to compute the yields

on both the tax-exempt and the taxable funds.

option: the right to buy or sell something at a specified price within a specified time period.

As a general proposition, an investor's decision as to whether to purchase a tax-exempt or a taxable security depends largely on his or her marginal tax rate and the rates being paid on the tax-exempts and taxables. The after-taxes return on a taxable security is $r(I-t)$ where "r" is the before-taxes rate of return on the taxable security and "t" is the investor's marginal tax rate.

The diversity of mutual funds allows you to create an investment strategy similar to those employed by professional investment managers. Their experience shows that one of the best approaches to managing money is to have a "balanced" approach. In effect, this approach means that you should not invest totally in stocks or totally in bonds, but you should have a mixture of both. The multitude of funds allows you to do just that. Your age and your household's stage in the life cycle should ultimately determine the allocation between various kinds of fund investments.

For guidance, a broadly based stock or equity fund could make up 45 percent of your portfolio of funds, while a good tax-exempt bond fund would comprise another 45 percent of the portfolio. The remaining 10 percent could be held in a money market fund until you decide to increase your position in either the stock fund or the municipal bond fund. This kind of strategy should lead to increasing returns for your portfolio and also to greater appreciation and understanding of the investment process.

Unit Investment Trusts

A unit trust is a broadly diversified, professionally selected portfolio of many individual bonds. They are similar to individual bonds in that they pay regular interest and return all of the investor's money when the bonds mature. Unit trusts pool the money of many investors to buy bonds of the same type, and they are much safer than individual bonds because of the diversification.

These trusts typically invest their assets in municipal bonds and other debt securities. Units in a trust are often sold to the public in \$1,000 denominations. Distributions of interest may be made on a monthly, quarterly, twice-a-year, or annual basis. Some unit investment trusts may offer automatic reinvestment of distributions, either in the trust or in a mutual fund run by the same sponsor.

In contrast to the tax-exempt mutual funds, unit investment trusts (UITs) offer fixed portfolios of securities that rarely change, even if

interest rates increase—unless a particular bond issue runs into trouble. A unit trust is a passive investment in that its assets are not traded but held to collect income and the eventual repayment of the principal.

On the other hand, UITs cannot take the advantage of quick changes in the marketplace, as can mutual funds. Further, although UIT owners receive a steady stream of interest income, these owners do not get their principal until the trusts expire, which can take from 3 to thirty years.

A serious disadvantage of Unit Investment Trusts is the call feature that is contained in many of the bonds in the UIT portfolio. This means that some of the 30-year bonds in the portfolio have the potential of becoming 10-year bonds or even 5-year bonds. States, municipalities and corporations will call their bonds during periods of low interest rates to refinance huge amounts of long-term debt. Thus, investors who bought bonds yielding 10 percent may have their principal returned when alternative investments are yielding a mere 6 percent.

If you decide to invest in tax-exempt unit trusts, try to find some way of evaluating the quality of the bonds in the trust's portfolio. You might find some information on the bonds in the trust's prospectus. Your objective should be a trust's portfolio with bonds that have "investment grade" ratings—"Baa" or higher at Moody's Investors Service, Inc. and "BBB" or higher at Standard & Poor's Corporation. Unit trusts are attractive to certain investors, such as, retirees who seek a steady and periodic flow of payments. If such investors need their money for emergencies, the shares may be sold back to the trust at their current net asset value.

About one-half of the tax-exempt unit trusts now in operation carry some form of insurance to protect bondholders against default. Insurance usually gives a trust a triple-A credit rating, but it can also reduce an investor's returns by 30 to 40 basis points. (One basis point is one hundredth of a percentage point.)

CLOSED-END INVESTMENT COMPANIES

Unlike a mutual fund, a closed-end investment company does not continuously offer to buy back its shares at the options of its shareholders. Such a company also does not continuously offer to sell its shares. After an initial sale by the company, the shares are traded in the secondary market like the shares of any other public corporation. Their price may fluctuate in response to changes in the value of a company's portfolio as well as the supply of and demand for its shares. When shares of such companies are traded with the services of a broker, it is customary for a commission to be charged.

As recently as 1989, the SEC cautioned investors on buying closed-end stock and bond mutual funds during the initial offering of these funds because the shares almost always trade at significantly lower prices later on. This word of caution resulted from a tracking of the value of these funds from 1985 to 1987.

The main reason for the higher price of closed-end mutual fund shares during the initial offering is that the offering includes underwriter's fees that range as high as 8 percent, which is far higher than the typical broker's commission that the investor would pay on the purchase of shares at some later date.

An investor should understand that the price of a share in a closed-end fund after the initial offering may reflect *only* changes in investors' demand for the limited number of fixed shares in the fund rather than any change in the total value of assets held by the fund. This means that the price of an investor's share could increase, but he or she would get no more money than before if the fund is suddenly dissolved. This is a different scenario from "open-end" mutual funds in which there is no limit on the number of shares issued and where the price of shares reflect the total value of assets held by the fund. In this case a higher share price would mean more money for the investor if the fund is suddenly dissolved.

For those investors who are anxious to test the junk market in some manner, a closed-end fund may be less risky than the other entries into this market. Even with a better-quality open-end junk bond fund, mass redemptions by shareholders could hurt the remaining shareholders because a fund manager could be forced to sell bonds in the fund's portfolio at fire-sale prices to raise cash. As stated earlier, a closed-end fund has a fixed number of shares outstanding that trade publicly just like stock. Thus the fund does not have to deal with daily sales and redemptions.

GINNIE MAE FUNDS

Ginnie Mae is a sort of nickname for GNMA, which, in turn, stands for Government National Mortgage Association, a federal agency that guarantees privately issued securities backed by pools of federally insured mortgages. This agency buys mortgages from lenders, pools them and then sells shares in the pool to investors. The investors receive their proportionate part of the monthly interest and principal payments made by the home-owners on the underlying mortgages.

Because of the relatively high minimum of \$25,000 for individual Ginnie Mae certificates, we now have Ginnie Mae mutual funds, in which the purchased price of shares and units range from \$1,000 to \$25,000. Ginnie Mae mutual funds are actively managed and must invest at least 65 percent of their assets in Ginnie Maes. Other

investments may be in bonds from other governmental agencies and collateralized mortgage obligations. Because the Federal Government guarantees that interest and principal will be paid on Ginnie Mae securities, the investor's funds in these securities are safe.

As in the case of investing in other securities, prospective investors should read the Ginnie Mae fund prospectus thoroughly before any decision to purchase. These funds are devoid of any credit risk, and the yields are usually very competitive. Furthermore, with an investment in a Ginnie Mae fund, you do not have to concern yourself with the complexity of prepayments and the bookkeeping usually required to separate the interest earnings from the payment of principal.

If there is any disadvantage in investing in Ginnie Mae funds, it is associated with periods when interest rates are falling. When these rates begin to fall dramatically, homeowners with relatively high mortgage rates take steps to refinance their mortgages to secure lower rates, and consequently, lower monthly payments. When this takes place, some of the higher-rate mortgages are replaced with lower-rate mortgages, and this lowers the yield of the Ginnie Mae funds to investors. In some instances, the diversity of the fund's portfolios will help to offset this development.

FUTURES FUNDS

A futures contract is an agreement between a seller and a buyer that obligates the seller to deliver to the buyer a specified item, during a defined period in the future, at a price that is agreed upon when the contract is first entered into. The most popular futures contracts are written on agricultural products. A growing number of contracts, however, are written on financial items, such as, Treasury securities, stocks, indexes, and currencies.

Since the focus of this book is on personal investments in financial instruments, it is important at this point to note that future contracts on financial instruments are used in **hedge positions** by financial institutions and borrowers to lock in yields. As interest rates and securities change, the yields from lending and the cost of borrowing change. Thus to reduce the risk of loss from, say dramatic changes in interest rates and prices, borrowers, lenders, managers and so forth, may establish hedge positions to lock-in a particular interest rate or price.

For the individual investor, hedging would not be the incentive for entering the futures market. The individual investor would be interested in reaping the profit for taking the risk. In other words, the individual investor would function as a speculator who seeks to predict correctly changes in prices and interest rates, and to take a

position on these factors that will yield profits.

For the most part, individual investors should shy away from futures contracts or “futures” as they are often called. For one thing, futures are very risky, and the potential financial rewards do not justify the risks involved. Also, to participate in the futures market, the investor would need to retain a trading advisor and the more experienced advisors require a minimum commitment of \$100,000, and some do not accept commitments of less than \$2 million.

If an individual investor is determined to get involved with futures, perhaps the best vehicle would be an investment in so-called managed futures, an arrangement similar to mutual funds. These funds can be very costly, in that fees and commissions bring the total yearly cost for the investor to about 11 to 13 percent. By comparison, stock mutual funds average about 1.5 percent in yearly total cost to the investor, excluding any initial sales charge.

MUTUAL FUND STATEMENTS

As an investor in a mutual fund, you are likely to receive a whole host of communications from the investment company that operates the fund. All of these communications are apt to be “official-looking” documents.

When stock shares are bought and sold, for example, stock funds send out confirmation slips; quarterly statements; and an Internal Revenue Service Form 1099 at the end of the year. Most bond funds send statements if and when dividends are reinvested. In short, the volume of communications can easily test your patience and perhaps provoke you into throwing them all into the trash basket, or at best, into skimming over them very lightly without paying very much attention to any of them.

While you may have good reason to regret your role in creating this new “pen-pal,” you should not overlook the fact that this relationship involves your money and that neglecting any one of these communications could result in the loss of your life-time savings. Some of these communications, formally referred to as fund statements, provide very important information on transactions that amount to verification of such things as prices and total value of your holdings that should be a part of your financial records. Other statements provide information that you need to file with your income taxes. As particulars to look for and to review in these fund statements, you ought to consider the following:

Fund Activity. This is a category of particulars that includes such items as; the beginning balance of your account; number of shares owned; current balance.

Share Purchases. This could include new investment money from you; capital gains distributions; and reinvested dividends.

Capital Gains Distributions. This figure may be needed for filing your income taxes.

Transactions Dates. All dates of fund activity can be important to you for a variety of purposes.

Others. This could include redemption of shares by you and fees charged by the fund.

Upon receipt of a communication from your mutual fund, one of your tasks will be to determine whether the document is a sales promotion piece, a questionnaire, a request to lobby for or against certain legislation that might affect mutual funds, or a legitimate fund statement. You have a further task of deciding whether it is an update that allows you to throw away a previous statement.

You can never go wrong by retaining all fund statements (or as many as your filing space will permit). Moreover, you should read these statements carefully and compare the information with your own records to reconcile any differences.

GUIDANCE AND DECISIONS

Indeed some investors may be better off with a portfolio of securities purchased directly from a discount broker or a federal reserve bank and a variety of mutual funds. In fact, this may not be a bad idea because a mixture of this nature reflects the kind of diversification suggested for all portfolios. Once a decision is made, however, to include mutual funds in this mix, funds should be chosen on the basis of how the funds relate to the priorities in the investor's financial plan. If the privilege of writing checks is a top priority, then the investor should choose a fund with low check minimums and no check-writing fees. If the top priority is additional income, then the investor should find a fund with a fairly high yield and take out the capital gains and income distribution in cash as against selling shares. If there is a greater concern for safety than anything else, a government-only fund should be the first choice. And, if the primary objective is to lower one's tax liability, then the obvious choice is to invest in a tax-free fund.

CHAPTER 11

MORE MONEY FOR RETIREMENT

Does the following:

- . . . 1. Stresses early start on financing retirement.
- . . . 2. Reviews the best investments for financing retirement.
- . . . 3. Scrutinizes the details on annuities.
- . . . 4. Looks at the attractiveness of 401 (K) Plans.
- . . . 5. Discusses investing after retirement.
- . . . 6. Examines reverse mortgages, “new kid on the block.”

CHAPTER 11

MORE MONEY FOR RETIREMENT

How much money will you need during your retirement? Are you sure about this amount? Why not more? How much more? Can you really answer these questions without knowing the answers to the following questions:

- . . . Do you have financial mechanisms in place to finance your retirement?
- . . . How much can you save before you retire?
- . . . When will you retire?
- . . . What will be your total income at the start of your retirement?
- . . . How much income will you need for your planned lifestyle during retirement?
- . . . What will your health expenses look like during your retirement?
- . . . Will you remain in the “old homestead” throughout your retirement or will you eventually move to smaller quarters?
- . . . Will you ever move to a retirement home or be placed in a nursing home?
If so, will your currently planned retirement income be sufficient to cover the cost of these homes?
- . . . If you are already retired, could you really use more money?
- . . . If your current retirement income is adequate, are you certain that it will continue to be adequate for the remainder of your retirement?
- . . . Finally, how long will your retirement last?

If you are still working and not retired, you probably cannot answer any of these questions with any degree of certainty, or with any certainty at all. Then again, perhaps you should not be expected to know the answers to these questions. If you can accept this reasoning, then what can you do now and in the future to respond to these questions with the appropriate actions? To this question, the answer is fairly obvious, namely, you should save as much as you can, invest as prudently as possible, and manage your investments from beginning to the end.

THE RIGHT OUTLOOK

All of us hope to live long enough to retire. This means that we all should take appropriate steps before retiring to assure a comfortable and enjoyable life during our retirement, and we all should learn as

much as possible about those matters that will not only help us to sustain this mode of living for ourselves, but help others to enjoy the same type of experience.

Contrary to popular thinking, retirement does not necessarily bring about a net reduction in expenditures, along with a reduction in income. For example, as a retiree, you may no longer have to pay commuter costs, maintain an up-to-date wardrobe and buy lunch in fancy restaurants. But your church and charitable contributions, mortgage or rent payments, and utility bills are unlikely to change. At the same time, other expenditures may well increase. Among these are gifts, travel and the cost of maintaining your health. To offset these adjustments in expenditures, you may have to rely solely on occasional cost-of-living increases in your Social Security.

Many families feel that it is too early to think about financing retirement while they are in their early or mid-twenties. They feel that priority should be given to buying things for their children; financing a home, two cars and other big-ticket items; and directing their investments toward financing their children's college education. These priorities are indeed worthy of their attention. However, young families should not overlook the experience of their predecessors. This experience shows that while Social Security benefits and pensions are important sources of income during retirement, earnings from investments usually spell the difference between a comfortable retirement and just getting by.

At the other end of the spectrum, many retirees, feel that it is too late for them to think about investing. They insist that concerns about such things as budgeting, saving, and investing are for young people and that senior citizens should simply place all of their surplus funds in a passbook savings account and forget about such things as reading the financial pages in the newspaper, comparing rates of return on various financial instruments, and considering whether the interest earnings from a particular security are tax-free. Indeed all of these activities do require expending a certain amount of energy, and it is logical to assume that retirees do not have as much energy as before and that they no longer have the same incentive for taking steps to increase their incomes. From another viewpoint, however, all retirees should feel obligated to get the most out of their current financial resources. Further, they should feel obligated to assure that their assets can produce enough income to support a comfortable lifestyle and meet all necessary expenses for their upkeep for the remainder of their lives. With these factors in mind, retirees should consider post-retirement investing just as important as, or even more important than, pre-retirement investing.

RETIREES SHOULD CONTINUE TO MONITOR THE WORLD'S ECONOMIC AND FINANCIAL MARKETS

To maximize the monetary return from their current assets, retirees should try to keep generally informed about economic and financial developments everywhere in the world. This will enable them to understand the elements that can considerably affect the return on their investments. Keeping informed can be as simple as reading the newspaper everyday or viewing the news programs on TV.

FINANCING RETIREMENT

Until recently, the prevailing opinion among younger households was that any need for additional financial resources during retirement would come from the household's own frugality and enough self-discipline "to defer current gratifications" for later comfort. A couple of important unknowns in this theory, however, were the length of retirement that could be expected and any change in economic conditions that could turn "sufficient" financial resources into those identified with the poverty level.

According to figures released by the Metropolitan Life Insurance Company on June 27, 1987, Americans' life expectancy had reached 75 years. This gain came after two years in which average life expectancy had remained steady at 74.7 years. The expected life span was even greater for those who were older. Women who reached the age of 65 in 1986 had an average of 18.9 more years to live and men 14.7 years.

For sure, the aforementioned data clearly shows that the average age of Americans is increasing, and is expected to continue to increase up through the year 2020.¹ Further, the data show that those persons who are fortunate enough to reach age 65 can count on living many more years. When these facts are coupled with surveys showing that many people are retiring at age 62 or at 65, the implications for financing one's retirement should come through loud and clear.

Although it is never too soon to start planning for retirement, most wage earners are in a better position to save and consider sizeable investments after their children are grown and the mortgage consumes a smaller portion of their total income. Also, most wage earners at this stage are much more knowledgeable about investments and have more time to investigate and analyze their choices for investments. How much money you will need will be determined not only by the life expectation of both you and your spouse, but also by your anticipated lifestyle. Consultants traditionally advise a necessary income at 75 to 80 percent of pre-retirement earnings to continue the same lifestyle.

In the final analysis, your planning for retirement may well involve two crucial factors. The first may be your willingness to reduce expenditures. The second may be your ability to increase income through investing.

REMINDERS ON SOCIAL SECURITY

Social Security constitutes a very important source of income during one's retirement, but it is not, nor was it ever intended to be, a total provider during one's retirement. While a married couple, retiring at age 65, and entitled to maximum individual benefits, could count on receiving \$26,112, as recently as 1992, data shows that social security still replaces only 30 to 40 percent of the pre-retirement income of the average retirement. The remainder is filled from the sources listed in Table 11-1, and as this table shows, the important sources are from the accumulated savings of the retirees.

Another important factor is that after the year 2,000 social security will replace an even smaller proportion of preretirement income of the average retirement income for those workers who retire at age 62 and who were born after 1937. For example, today's workers who retire at age 62 receive 80 percent of the full benefit they would have received if they continue to work until age 65. Workers born after 1937 who retire at age 62 will receive about 79 percent of their full retirement benefit. Those born between 1943 and 1954 will receive 75 percent if they retire at age 62. People born in 1960 or later who retire at 62 will receive 70 percent of their full benefit amount. This factor is important because the trend since 1960 has been toward earlier and earlier retirement. In fact, about 50 percent of workers now elect to receive their first Social Security retirement check at age 62 rather than age 65.

Table 11-1
Sources of Income for Persons Ages 65 and Over

Source of Income	Percentage
Social Security	40.5
Interest, dividends, rents & royalties	24.0
Pensions and Annuities	17.4
Earnings (salary, wages and self-employed earnings)	15.5
Supplemental Social Security Income and Public Assistance	1.4
Other sources (alimony, gifts, veterans payments, etc.)	1.2

Source: 1987 Current Population Survey, U. S. Bureau of the Census

The same 1983 Social Security legislation that called for reduced percentages of full retirement benefit for workers who retire at age 62 and were born after 1937, also mandated a gradual increase in age at which workers can receive *full* retirement benefits. Beginning in the year 2000, workers born after 1937 will have to be 65 years and 2 months to receive full retirement benefits. Table 11-2 shows how the retirement age will increase in 2-month increments until it reaches age 67 in 2027.

Table 11-2
Age for Full Social Security Benefits

Year of Birth	Full Retirement Age
1937 or earlier	65
1938	65 and 2 months
1939	65 and 4 months
1940	65 and 6 months
1941	65 and 8 months
1942	65 and 10 months
1943–54	66
1955	66 and 2 months
1956	66 and 4 months
1957	66 and 6 months
1958	66 and 8 months
1959	66 and 10 months
1960 or later	67

Source: Federal Reserve Bank of Richmond, *The Fedcaster*, July 3, 1992 plan as part of its benefits package.

The gap between social security benefits and the total income needed by the typical retiree for a comfortable living should not come as a surprise. After all, Medicare benefits are limited; they typically cover less than one-half the health-related expenses for the elderly; some services are only 80 percent covered; and nursing home costs often are not covered at all. On top of all of this, both Medicare and most private health insurance plans require co-payments and deductibles.

The bottom line here is that people should not overestimate the contribution of social security on their financial needs during retirement. People should begin to save as soon as they draw their first paycheck, and they should devise and implement an investment strategy for these savings, with a view not only toward increasing their current income, but also toward supplementing traditional retirement income after their working career is over.

401 (K) PLANS

Whenever you are considering a job and you are reviewing the employee benefits offered by the employer, number one on your priority list should be the health benefits, but followed closely by a 401 (K) plan or thrift-savings plan with matching participation by the employer. All employers do not offer such a plan. However, you should become acquainted with all of the particulars of the 401 (K) plan and seek an employer that has the plan as part of its benefit package.

Outline of the Plan

Participating in a 401 (K) plan can be one of the best ways of financing your retirement. This plan gets its name from Section 401 (K) of the Internal Revenue Code (IRC) that allows qualified cash or deferred arrangements that produce special tax advantages and increase retirement benefits. Specifically, this plan allows employees to contribute a portion of their pay (up to \$7,979) to qualified savings vehicles as pre-tax salary deductions, and allows employers to contribute a percentage of this pay into the plan on the employee's behalf. All funds in the employee's 401 (K) account are deferred from income taxes and can be withdrawn at age 59 1/2 without incurring an IRS penalty of 10 percent. Prior to age 59 1/2, withdrawals from the account are permitted only at the employee's death, disability, or termination of employment. Taxes must be paid on the amount of money withdrawn.

The beauty of the 401 (K) plan is that your retirement income from this program consists not only of your accumulated savings and interest on those savings but also the funds contributed by your employer and the interest on those funds as well. Thus, in addition to having your employer help with the financing of your social security benefits, you, as an employee, would have the help of your employer in financing another part of your retirement income.

Widespread Participation

Fortunately, you don't have to look hard to find an employer that offers a 401 (K) plan. A survey by the Washington, D. C.-based Employee Benefits Research Institute of more than 250 major employers, found that from the years 1981 to 1987, the number who offered 401(K)'s rose from 0% to 91%. Participation by employees is also widespread. In *Current 401 (K) Plan Practices: A Survey Report*, Buck Consultants, a New York City-based benefits consulting firm, surveyed 424 companies in 1989 and found that 57% of companies in the United States had 67% to 100% participation among their

employees, while only 10% had less than a 33% participation rate. One of the most publicized 401 (K) plans is in the Federal Government. Over 1.5 million federal workers, about half the total work force, are participating, and their accounts are earning \$1.3 million every day.

Responsibilities for the Employee

In the jargon of employee pension plans, the typical 401 (K) is referred to as a “self-directed” retirement plan. In this type of pension plan, each employee is allowed to choose from a variety of financial instruments for investing his contribution and the matching contribution of the employer. The choices usually include such instruments as stock funds, bond funds, guaranteed investment contracts, and money market funds. As you can imagine, an employee’s selection can have a significant effect on the amount of his or her monthly pension.

This responsibility for selection of investments can work to the disadvantage of employees, particularly those who are unfamiliar with financial instruments and investments in general. Experience shows, for example, that most employees choose only the most conservative instruments such as bond funds and guaranteed investment contracts. They tend to shun equities or stock funds. According to U.S. Department of Labor figures, nearly 75 percent of all employees with self-directed plans have *none* of their contributions in stocks. Only 3.7% of employees have one-half of their contributions in stocks.

Many professional money managers believe that stocks are a very good hedge against inflation, and over a long period of time, will produce a greater rate of return than fixed-income instruments. Although the data show that this relationship will vary during specific time periods, it would seem advisable for employees in a 401 (K) plan to diversify the investments for their contribution to the plan. If, for example, a plan offers two choices, namely stocks and fixed-income, a good choice would be to place one-half of the contribution in each.

Loan Privileges

Under some 401 (K) plans, employees are permitted to borrow from their 401 (K) accounts, with their employer’s permission. The employer sets the interest rate, but the loans are also governed by rules set by the Federal Government. Borrowing from one’s retirement is by no means advisable. But if you feel compelled to do so, a loan from your 401 (K) has certain advantages over other sources. In the first, place you qualify for the loan simply because of your participation in the plan. Second, the interest you pay on the loan, in

most cases, goes right backs into your retirement account.

INDIVIDUAL RETIREMENT ACCOUNTS (IRA'S)

To be sure, the IRA is not what it used to be before the Tax Reform Act of 1986. Never-the-less, the IRA can still be the “best answer for more money” during retirement, particularly if the retiree is not covered by one of the employer-provided pension plans, including 401 (K) plans. Of course, anyone who earns income can still contribute up to \$2,000 per year to an IRA account and earn tax-deferred interest on his or her money. The IRA is simply a personal savings plan that offers you tax advantages if you decide to set aside money for your retirement. It should be noted that although interest earned from your IRA is generally not taxed in the year earned, the interest is not *tax-exempt* and should not be reported as such on your federal income tax form.

For even more money during your retirement, you may be able to establish and contribute to an IRA for your spouse, whether or not he or she received compensation. This is called *spousal* IRA and is generally set up for a nonworking spouse.

Tax-deductible contributions to IRAs are still available to individuals with incomes up to \$25,000, to married couples with combined incomes up to \$40,000, and to those at any income level not covered by employer-provided pension plans. If one spouse is covered by a plan, the other spouse is not eligible for a full IRA deduction on a joint tax plan. Also, if you and your spouse each contribute to an IRA, the contribution limit for each of you is figured separately. The most that you can contribute for any year to your IRA is *the smaller* of the following amounts:

1. Your compensation that you must include in income for the year, or
2. \$2,000

The total combined contribution you can make each year to your IRA and a spousal IRA is *the smaller* of:

1. Your taxable compensation for the year, or
2. \$2,250.

You can divide your IRA contribution between your IRA and the spousal IRA any way you choose, as long as you do not contribute more than \$2,000 to either IRA. You can establish different kinds of IRAs with a variety of financial firms, institutions and organizations.

You MAY begin withdrawing the money in your retirement account without penalty at age 59 1/2 or if you become disabled. You MUST begin withdrawing before the end of the year in which you reach 70 1/2. Withdrawal may be in a lump sum or on a monthly, quarterly, or annual basis. Withdrawals are considered to be income

and, as such, are subject to income tax. But you probably will be in a lower tax bracket at the time.

Premature distribution (before age 59½) is subject to income tax and a 10% penalty tax. Additional penalties may also be incurred, such as the mandatory penalty for early withdrawal of certificates of deposit.

KEOGH PLANS

A Keogh plan is very similar to an IRA. One major difference is that the Keogh plans are for self-employed people such as small business owners, doctors, dentists, lawyers, writers, and others who work for themselves and do not incorporate their businesses. Another major difference is that these self-employed persons can contribute up to \$30,000 a year to their plan, compared with \$2,000 for workers who establish IRAs. The rules on withdrawals (also called “distributions”) from Keogh plans are similar to those for IRAs.

ANNUITIES

Not knowing how long they are going to live and how much money it will take to care for themselves adequately during their declining years, many people are seeking to provide themselves with more funds in retirement than those traditionally produced by social security, pensions, 401 (K) plans, and earnings from securities. Annuities are becoming one of the popular sources for providing these additional funds.

Annuities are contracts between an investor and an insurance company, in which the investor makes a series of payments over a period of time, or in a lump sum, for the purpose of receiving income at a later date. Annuities are sold by insurance agents, stockbrokers, and financial planners. The investor may pay for the annuity with either an annual premium or a single premium. Although the investor can buy an annuity that pays income for only a chosen number of years, most annuities provide an income for life. Annuities are very appropriate for entertainers, professional athletes, and other performers whose employers do not offer pension plans. These individuals should buy a deferred annuity, which means that their income will start later. People who find themselves with large sums of money at one time, such as lottery winners, should pay a lump sum premium. These are commonly referred to as *single-premium annuities*.

Most annual-premium deferred annuities provide for a “flexible premium.” This means that the investor can purchase the annuity with a particular premium in mind, but can pay more or less on each premium due date, as his or her finances permit.

An investor can buy a *fixed dollar* or a *variable annuity*. With the fixed dollar annuity, both the principal and a minimum interest rate are guaranteed for the period of the annuity contract. With a variable rate annuity, there is no guarantee of a rate of return since earnings are based on investments in securities that can fluctuate in value. The annuitant can allocate money among several different mutual funds, which invest in stocks, government securities, and corporate bonds. For more money during retirement, it may be advisable for annuitants to allocate most of their money to stock funds that invest largely in stocks of smaller companies, growth stocks, and stocks noted for paying good dividends.

Investors should buy annuities with caution. Even with the fixed-rate annuity, the guarantees are as good as the financial stability of the firm that issues the annuity. Most financial advisers suggest that investors buy annuities from insurers whose financial strength is rated A+ or A by the A. M. Best Company in Oldwick, New Jersey.

ARE ANNUITIES SAFE?

Annuities are issued by insurance companies, therefore, annuities are as safe as the company. For reasonable safety, you should consider annuities only from insurance companies with high ratings from rating firms, such as, A. M. Best Co., S&P, Moody's or Duffs & Phelps are not insured by the Federal government.

In addition to investigating the soundness of the firm issuing the annuity, the investor ought to take note of the annual charge by the issuing firm for servicing the annuity contract. Traditionally this charge has been 1.25 percent of the amount of money invested. If the annuitant's funds, however, are invested in, say a fixed-rate investment with low returns, this annual contract charge can offset much of the benefit of the tax-deferred advantage of the annuity.

principal: the investor's payments, less expenses

To be sure, annuities are good long-term investments for persons planning for more money during retirement. Aside from the additional monthly income for the annuitant, the annuitant's heirs will get no less than the investment principal in the event the annuitant dies before withdrawals are made. A further advantage is that the annuity assets are protected from creditors in bankruptcies and even lawsuits in many states. On the other hand, there is a problem for those annuitants who decide to withdraw their money before they reach 59 1/2 years of age.

The federal government imposes a 10 percent penalty tax on most

money withdrawn before the investor reaches age 59 1/2. Also, **accumulated gains** are subject to ordinary income tax rates when they are withdrawn as income.

INVESTMENTS AFTER RETIREMENT

Many of the investments used to finance retirement can also be used to finance post-retirement. This certainly includes the investments discussed in Chapter 3. As you may recall, these investments were favored because they are easy to make; carry 100 percent safety; involve no advisor or agent or their fees; require no monitoring; and earn a respectable amount of income. Although no one can predict future interest rates or tax laws, it is highly likely that the income from these investments will be steady and that their rate of return will at least remain close to the rate of inflation.

With a thorough understanding of the discussion in this book, retirees should strive to do better with their investments than simply “keeping up with inflation.” Having made considerable sacrifices throughout their working careers, retirees deserve the opportunity to enjoy some of the “extras” that life has to offer. Thus retirees should supplement the fairly conservative investments discussed in Chapter 3 with investment instruments that might not carry maximum safety, but will produce a level of income that will support an enjoyable living.

accumulated gains: interest earned on the premiums over the life of the annuity.
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Tax-free Securities

This may also be somewhat of a repeat of a previous discussion, namely the information presented in Chapter 8. It bears repeating to say that municipal bonds, particularly general obligation bonds, carry two important advantages. One of these is safety. The other is that they are exempt from all federal, state, and local income taxes if the purchaser lives in the state where the bonds are issued.

At one time, many investors were hesitant to buy municipal bonds because most of these bonds were issued in bearer form. This meant that if the bonds were stolen or lost, the investor would lose the entire investment. This was changed in the early 1980's when Congress eliminated the issue of tax-free bonds in bearer form to discourage tax cheaters. Thus retirees should feel comfortable in buying municipal bonds for their tax-free status because this status provides the retiree with more current income to enjoy life.

Another point to be made here is that retirees should not concern

themselves with the difficulty of selling these bonds in the secondary market or with the long maturity of the bonds. They should simply enjoy the higher rates of return on the long-term bonds and should hold such bonds as long as possible.

Stocks

One of the key points discussed in Chapter 4 is that certain stocks can be bought for the purpose of supplementing the household's income to accomplish this, investors were advised to buy the stock of companies with a history of paying relatively high dividends and paying these dividends on schedule. It was suggested that utility company stocks usually fit this purpose better than other stocks.

While it is suggested that utility company stocks are definitely appropriate for meeting this objective, the retiree should still pick and choose among the utility companies. Based on their histories, some companies will meet the objective better than others. Retirees must monitor stock quotations in the daily newspapers, and be willing to undertake all of the other responsibilities of a stockholder or potential stockholder, such as reading the company's prospectus.

Bonds

It goes without saying that long-term bonds are an excellent source of retirement income. These bonds have two characteristics that make them perfect investments for this purpose. The first is that long-term bonds traditionally pay higher interest rates than those with short-term or intermediate-term maturities. The second is that bonds have fixed rates of interest. Thus the retiree does not have to worry about fluctuations in his or her income from this source.

As suggested in earlier chapters, all investors should be on guard against trading safety for high yields. This caution is particularly relevant when investing for retirement.

Many middle-age employees are very sensitive about buying, say, 30-year bonds for retirement income. Their typical comment is, "I might not live for thirty years. Why should I buy something that I cannot collect before 30 years? Suppose I need my money before the thirty years are up?" Of course, there are reasonable responses to each of these questions, but all of them can be summed up by merely citing the purpose of an investment made to help finance one's retirement. This type of investment is made to produce a reasonably satisfactory rate of earnings, for an extended period of time, with little or no risk to the earnings. The principal of this investment should never be liquidated or spent because the retiree never knows how long he or she will live and thus need the income. Further, if a dire emergency

does arise, bonds, treasury bonds in particular, can always be sold in the secondary market.

REVERSE MORTGAGES

For retirees age 62 or over who own their homes outright and are looking for additional money either to close the gap in their monthly budget or to enjoy some of the nice ties of life that they have had to forego up to that point, a reverse mortgage might provide the answer. In a sense, a reverse mortgage is almost the opposite of the traditional mortgage in that a traditional mortgage calls for the homeowner to make monthly payments to the financial institution, whereas, the reverse mortgage calls for the financial institution to pay money to the borrower-homeowner. Although the borrowed money can be disbursed to the homeowner in a variety of ways, most homeowners to date seem to prefer the proceeds of the loan to be paid in monthly installments. In all forms, the payment of this money is nontaxable because it comes as a loan.

ALTERNATIVE PAYOUTS ON A REVERSE MORTGAGE

1. Lump sum
2. Line of credit that can be drawn on when needed
3. Term loan that pays monthly for a set period of time, becoming due at the end of the set period

Specifically, a “reverse mortgage” is a term used to describe an arrangement under which a homeowner borrows money from a financial institution using the equity in his or her home as collateral. The loan is repaid, including accumulated interest, when the homeowner sells the home or dies, enabling the financial institution to sell the home. The homeowner can draw down the loan in fixed amounts every month as long as he or she continues to live in the home. The homeowner does not have to meet any income requirements and retains title to the house until he or she dies. The Federal Housing Administration offers an insured reverse mortgage program through mortgage bankers in most states. There are privately insured programs that provide this same service.

Many elderly homeowners may hesitate to take out a reverse mortgage because they would like to “leave the home for the children.” This is certainly an admirable thought, but it may overlook a number of factors that could defeat the homeowner’s dreams. In a number of situations, for example, the offspring have their own home and would not consider giving up these homes for the “old homestead,” which in many instances, is older and located in a

different community than the one in which the offspring prefer to live. In such situations, the offspring are usually so anxious to sell the house that they accept a price which is below the value that the homeowner could have received for the reverse mortgage. Then, there is the situation in which the alternative to a reverse mortgage is monthly financial assistance from the offspring at a time when the offspring is straining to meet college and other expenses of his or her own children. Failure to get a reverse mortgage in this instance would not only place a financial burden on the offspring when they can least afford it, but also eventually would leave a home to the offspring when they do not need one or when they cannot utilize the funds from the sale of the house to affect their standard of living.

There is no question but that many elder homeowners would do well to investigate the potential of a reverse mortgage for meeting the ever-increasing expenses for such things as health care and various taxes, particularly local property taxes. The amount to be received from such an arrangement depends on the homeowner's age, the value of the home, and the various costs associated with the transaction, such as, the items in the traditional closing costs.

THE ENDLESS QUEST FOR MORE MONEY

Although an individual may retire from regular employment or a long-time profession, he or she should never retire from financial planning because there will always be a need for money. For one thing, a retiree may be 65 years old upon retirement, but recently developed mortality tables indicate that both males and females reaching this age have a good chance of reaching age 90. In fact, females have a good chance of reaching 95 years of age. Another factor is the inevitable continuation of inflation. What may be a comfortable pension today will likely be very inadequate 10, or maybe only 5 years, from now.

If financial planning for retirement starts early, as suggested in this chapter, it should, and will, become a habit that will persist throughout an individual's retirement. Early recognition of the need to invest and early familiarity with basic investment instruments will not only enhance this financial planning for retirement but will also serve as a motivation to remain updated on investing and reaping the most from efforts put into investing.

Perhaps the old adage, "One can never be too thin or too rich," is over-worked. However, if one can translate this adage to imply that the average person can never have too much income, even in retirement, then the philosophy behind the adage still makes a lot of sense.

Footnote

¹Stephen H. Chapman, Mitchell P. La Plante, and Gail Wilensky, “Life Expectancy and Health Status, the Aged,” *Social Security Bulletin*, vol. 49, no. 10 (October 1961), p. 44.

CHAPTER 12

MANAGING YOUR SOURCES OF MONEY

Attempts to Make Clear:

- . . . Why your investments need managing
- . . . Why investments need managing
- . . . The need for continuing education about investments
- . . . Who should be the ultimate manager of your investments

CHAPTER 12

MANAGING YOUR INVESTMENTS

Since this book is concerned only with financial instruments, this discussion could just as easily be labeled, “Managing Your Portfolio.” At any rate, the purpose here is to emphasize the need for investors to devote time and energy to reviewing periodically all of their investments and to taking whatever action is necessary to maximize the contribution of these investments to the household’s current and future financial needs. A portion of the discussion will also be devoted to the need for continuing the pursuit of information and advice about all matters pertaining to economic and financial developments, with a view toward using this knowledge to support those actions taken on behalf of the portfolio. When combined, these discussions will not only point to the need for managing your investments, but will also confirm the importance of the discussions in previous chapters.

CHANGING ECONOMIC AND FINANCIAL CONDITIONS

A grade of “A” should be given to those investors who feel that they must do something when they have a large amount of cash in a passbook savings account at a time when the Consumer Price Index is increasing from 4 percent in one year to 10 percent the next year. A similar grade should be given to those investors who redeem their 5-year, 6 percent CDs early and take the penalty when Treasury bonds are to be offered at a projected yield of 12 percent. Both groups of these investors deserve this excellent grade for realizing that changes in economic and financial conditions should necessitate some changes in their investments. To do otherwise, these investors would find that their financial plan is failing to provide them with the income needed to achieve their financial goals or failing to produce the full potential of the portfolio—something that might be needed to provide for increased financial obligations.

Economic Conditions

Changing economic conditions affect most, if not all, institutions

and organizations that depend on financial resources for their operation. Since World War II, the dominant change has been inflation. This change has forced these institutions and organizations not only to seek increased financial resources, but also to include a so-called inflation premium in all of their future plans of operation. Experience shows that households have responded to this development by demanding wage contracts that include both increased wages and a cost-of-living adjustment clause, often referred to as a COLA. Investors have not enjoyed this prerogative.

If an investor has a reasonably diversified portfolio, a significant portion of the portfolio will consist of bonds, CDs, and other debt instruments, including savings bonds. This makes the investor a creditor, and the bond issuer the debtor. During inflationary periods, the debtor repays the loan to the creditor with money that buys less than money initially loaned to the debtor. Thus to maintain the purchasing power projected in his or her investment plan, the investor is forced to make changes in the investments. These changes would include such options as increasing the amount of investments and exchanging some of the current investments for investments paying a higher yield.

Also, should investors be content with their current investments when the economy goes into a deep recession? Should they simply do nothing when their daily newspapers continue to run articles on the struggles of a company whose stocks constitute a large portion of their equity investments? How long should they wait before converting the stocks of near-bankrupt companies to safe investments like bank CDs (no more than \$100,000 in the same bank) and recession-proof stocks of food and pharmaceutical companies?

One can almost say that changes in economic conditions should be placed alongside “death and taxes” as certainties in our modern life. Among other things, the changes in economic conditions are certain to have an impact on our investments, and thus are certain to have an impact on our financial objectives and goals if we fail to take action.

EXAMPLE: INHERITED PROPERTY

If you have inherited securities, you may want to review them in light of changing economic conditions. The investments may have been appropriate when they were made, but may not be appropriate in light of current economic and financial conditions.

Also, tax-exempt bonds may have been appropriate for someone in a 33 percent tax bracket, but not for you if you are in a lower tax bracket. Taxable bonds may fit your circumstances a lot better.

Financial Conditions

While changes in financial conditions often track changes in economic conditions, there are many instances when certain changes occur in the financial conditions without any concomitant changes in overall economic conditions. Moreover, some of these changes in financial conditions can have a significant affect on your investments. If, for example, a change in tax laws make consumer-type borrowing attractive again, and thus puts pressure on bank reserves, causing the Federal Reserve to raise the discount rate, this series of developments could raise market interest rates and yields on Treasury securities. This in turn should persuade investors to review their portfolio for possible changes into Treasury securities. After all, in addition to higher yields, the investor should realize that interest earnings on Treasury securities are exempt from state income taxes.

CHANGES IN PERSONAL CIRCUMSTANCES

For most investors, there is a long period of time between his or her first job, when the setting of financial objectives and goals should be first established, and the day when absolutely all of the investor's activity comes to an end. During this period, there will no doubt be changes in the investor's personal life that will prompt changes in many of the investors financial objectives, as well as a few financial goals. Such developments or changes in the make-up of the household, changes in the health of household members, job changes for household members, changes in career objectives of household members, and changes in mortality rates can affect investment objectives and goals because all of these developments can result in changes in household income and expenses in both the short and the long run. Any change in the household's investment objectives and goals should necessarily bring a change in investments.

Needless to say, most changes in the investors' personal circumstances result in increased expenses, thereby calling for more income, instead of the opposite. Thus investors are often faced with the task of earning more income to increase investments or reviewing their portfolios for the possibility of obtaining higher yields on current investments. Of course, most investors are inclined to increase their personal income whenever the opportunity presents itself and when they are successful, they no doubt will increase their investment from increased saving. If the need for additional household income is pressing, however, the investor may not be able to achieve the desired adjustments in his or her employment immediately and may be forced to seek other ways of increasing household income.

For a specific example of a sudden change in an investor's

personal circumstances that could require additional household income, let's assume that the investor's widowed mother-in-law is suddenly forced to join the household with very meager resources of her own and an increasing amount of health expenses. Let's also assume that the investor has a portfolio with a substantial amount of growth stocks for capital appreciation. To help in meeting this new level of household expenses immediately, the investor could sell the growth stocks and replace them with utility company stocks which are usually considered to be good income-producing stocks. Another alternative might be the purchase of investment grade corporate bonds. Both of these changes could be made in the portfolio without reducing the level of investments in the portfolio.

Changing circumstances for every investor are inevitable. While this inevitability pertains particularly to the economy and financial markets, the potential for changes in the investor's own household is high enough to be included in this discussion. By affecting the investment objectives and goals of the household, these changing circumstances should cause investors to monitor and review their investments on a periodic basis with a view toward coping with these changing circumstances. In effect, monitoring and reviewing investments, followed by appropriate action amounts to managing the investments. Thus all investors should understand the necessity of managing their investments.

PERIODIC REVIEW OF PORTFOLIO

As an investor, you should develop a new worth statement once a year as a procedure in good personal money management. This provides an excellent opportunity to manage your investments because the recording of the monetary values and other data for various securities should accommodate the scrutiny needed to take any necessary action. For example, you should note whether any investments are yielding below market rates and whether they are scheduled to mature in the very near future. If you are in a period of rising market yields, you should seek to improve the yields on your current investments. If market yields are falling, you should seek to maintain the level of yields of your current investments or at least to minimize the loss on these yields.

Another focus of this periodic review should be the maturity dates of various investments. This is suggested as a means of keeping investors on a continuous search for new investments, both for the purpose of replacing those that are maturing and for the basic objective of searching for new ways of earning more money with that they already have. The investor should never have all of his or her liquid savings or cash invested at one particular time. To do so would

cause the investor to miss out on attractive offers of investment that may not be available again for quite some time.

NEED FOR CONTINUING EDUCATION

To complete the process for managing your investments, you need to follow up on the periodic review of your investments; but before taking any definitive action, you should make every effort to obtain the most up-to-date and sufficient information on investments. The basic sources of information are those discussed in Chapter 2, namely newspapers, magazines, books, financial advisors, prospectuses and friends. Often after consulting these basic sources, you may need even more information, or you may need a third party to respond to some of your questions and opinions. For this, you may want to add to the basic sources of information such things as seminars and adult education courses on investments.

Basic Sources

There is little need to repeat the discussion in Chapter 2 on sources of information and advice on investments. After learning the nomenclature of investments in a book such as the one you are reading, the updating of information on investments, and some of the more sophisticated training can be obtained from the other sources. Frankly, after digesting all of the information in this book, the average investor should need only the updating from the news media and other sources to manage his or her investments effectively.

Most of the information needed for action following the periodic review of your investments will pertain to such topics as interest rates, stock market activity, offerings of Treasury securities, gross domestic product, developments in the business world, actions by the Federal Reserve, and taxes. Traditionally, the best sources for this information are newspapers, broadcast media, and specialized publications. Newspapers, in particular are a very good source for information on changes in legislation affecting investments, changes made by regulatory bodies, such as the SEC, stock market quotations, yields on various securities, and recent trends in the economy. The biggest advantages for books is that they bring much of the relevant information on securities together in a single package which is very portable to places for leisurely reading, and also can be stored at home for later reference.

Face-to-Face Sources

Settings in which the investor can ask questions; request elaboration on various topics, strategies, and concepts; and “bounce”

theories and opinions of individuals with experience and expertise in investments are always beneficial to investors. Among other places, these settings are provided in classrooms, lectures, and seminars. The benefit applies to all investors at some stage in their lives regardless of their experience and expertise. The classroom setting, of course, will offer the investor information on basic topics, common strategies, and the importance of other crucial factors such as changing economic conditions. Further, the classroom setting will be free of any ties to a commercial organization with an interest in selling or publicizing a specific investment product.

Seminars, lectures, and symposiums on investments or on subjects that include investments, are often sponsored by local financial institutions such as banks, thrifts, and brokerage firms. As implied above, these institutions often use these occasions as a forum for pushing their own investment products. On the other hand, the speakers are usually people with long experience in their fields, and thus the audience can always glean bits of useful information from the discussion, and utilize the opportunity for questions to pinpoint areas of special interest.

INVESTOR AS THE ULTIMATE MANAGER

If you have a considerable amount of investments, it may be to your advantage to consider hiring a portfolio manager, financial planner, personal money manager or some other type of professional to manage your investments. There's always comfort in knowing that your affairs are in the hands of people who get paid to manage such affairs. However you should be wary of those individuals who are simply traders of stocks and bonds, are insensitive to abrupt changes in your personal circumstances, and who may not be able to identify themselves with all of the nuances pertaining to your investment goals.

EVALUATING A PROFESSIONAL MANAGER'S VALUE

If you feel the need to hire a manager of your investments, (or a portfolio manager) you ought to have some idea on evaluating his or her performance. One suggestion is to compare his or her performance with an appropriate index, such as the Standard & Poor's 500. A good manager should make more than this index, or at least lose less.

In the final analysis, the real proof of a manager's value lies in his ability not just to make money for you in good times, but also to preserve your capital when things are not so good.

For the amounts of resources that the majority of investors can

commit to investments, professional management is not needed. The time, energy, expertise, and attention required for these levels of investments are well within the limits of these people, and if applied diligently, can result in effective management. The important factors for these investors are as follows: (1) to understand the need for managing their investments; (2) to have the discipline to review their investments on a periodic basis; and (3) to act promptly when adjustments are needed to keep their investments in line with their investment objectives and goals and (4) to pursue continuing education about investments through whatever means are available.

Those investors who feel that, once investments are made, little or no attention is needed afterwards should take note of a recent experience by an heiress in a large metropolitan area. It seems that she inherited four square blocks of real estate a couple of decades ago. During these years, this real estate produced a considerable amount of income for the heiress and her family because the four blocks were located in the heart of a very large city. The management of the real estate was left in the hands of a realty firm, and thus, the heiress saw no need to devote any attention to this particular investment. After several years, many of the tenants in the four-block area began to move to the surrounding suburbs. Finally, the four-block area became desolate, leaving the heiress with a worthless investment and no income. In other words, she felt that her investment needed no attention; she failed to note the changes that were affecting her investment; and thus she never took any action to keep her investment in line with her investment objective, namely to provide adequate income for her and her family.

Managing one's investments should begin with the first investment and should never end. The investments, as a whole, should continue to grow and play a vital role in producing more money for the household and in achieving the investor's financial and economic goals. The investor need not be a Wall Street genius to achieve these goals through management of his or her investments. The only talent needed is to understand the meaning and importance of the task.

GLOSSARY

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Accrued interest: interest earnings accumulated on a financial interest bearing asset.

Accumulated Gains: interest earned on the premiums over the life of the annuity.

Adjusted gross income: gross income (total income) minus any allowable adjustments to income.

Affinity Credit Card: a card issued by a nonbank group or organization to its members, in an arrangement with a bank.

Agencies: securities issued by such federal agencies as the Federal Land Banks, Federal National Mortgage Association, Government National Mortgage Association, and the Tennessee Valley Authority.

Aggressive growth stock fund: a mutual fund in which the portfolio of securities consists mostly of stocks that are expected to appreciate in value in the very near future.

All-signature account: an account owned by two or more persons arranged so that signatures of all joint owners are required for transactions.

Amortize: to reduce a debt through regular and equal payments.

Annual percentage rate (APR): the cost of credit over a full year, expressed as a percentage, reflecting all costs of the loan as required by the Truth in Lending Act.

Annual rate: the rate of interest to be paid over a full year.

Annual yield: interest rate paid over a full year compounded.

Annuity: a guaranteed income for life, with payments received at regular intervals; a type of investment offered by insurance companies.

Appreciation: A term synonymous with price improvements or advance—a major objective of investment.

Arbitration: an agreement between two parties that a dispute will be settled by a third party, and that the decision of the third party will be binding on both disputants.

Arrears: amount due and unpaid.

Assets: any owned properties or rights that are available for the payment of an obligation. They include cash and readily marketable securities held as investments, other items considered the equivalent of cash, accounts receivable, merchandise

inventory, etc.

ATM: abbreviation for automated teller machines, which are computer controlled terminals located on bank premises or elsewhere, through which customers of financial institutions make deposits, withdrawals, or other transactions as they would through a bank teller.

Auction: the sale of Treasury securities by the U. S. Treasury on a bid basis.

Balance sheet: a statement showing the nature and amount of a company's assets, liabilities, and capital on a given date.

Balloon payment: a large extra payment that may be charged at the end of a loan or lease.

Banker's acceptances: a future claim on a bank backed up by the bank's customer; it enables the bank to finance the customer's business transactions—such as a shipment of goods by a third party.

Bankruptcy: an individual's status in which a state law usually allows the individual's creditors to claim his or her assets for repayment of debts (with certain assets or a portion thereof excepted).

Bearer bond: a bond that does not have the owner's name registered on the books of the issuing company or on the bond. Interest and principal are payable to the holder. Endorsement is not required on transfers.

Blue chip companies: large and fairly stable companies that have demonstrated consistent earnings and usually have long-term growth potential.

Bond: a special kind of promissory note that represents the issuer's pledge to pay back the principal on a certain date of maturity, at face value. Until that date, the issuer promises to pay an amount of money, usually every six months, at a fixed rate that is determined when the bond is issued. Unlike a stockholder, a bondholder does not share in profits or losses of the issuer or take part in business decisions.

Book-entry form: the Treasury merely establishes an account in the name of the buyer of Treasury securities. The purchaser receives a receipt and a statement of account.

Brokerage house: a firm, often a member of a stock exchange, that handles the public's orders to buy and sell securities. For this service, the firm charges a fee.

Buying on the margin: buying stock by making a down payment instead of paying the full price of the stock. The down payment is expressed as a percentage of the full price and is set by the Federal Reserve Board.

Call feature: the right of an issuer of bonds to retire the debt prior to maturity.

Call protection: the specific period of time during which a callable securities issue cannot be recalled.

Call provision: this gives its holder the option to buy stock at a fixed price within specified length of time from the writer or seller. Calls are purchased by those who think the stock price may rise.

Callable bonds: a provision in a bond document that gives the issuer the right to buy back the bonds from holders at the face amount before the date of maturity.

Capital gain: a gain or profit derived from the sale or exchange of a capital asset.

Cash management account: a form of investment offered by larger brokerage firms

and investment companies.

Ceiling interest rate: maximum rate of interest allowed by law or official regulations.

Certificate of deposit: a form of time deposit issued by depository institutions that cannot be withdrawn before a specified maturity date without being subject to an interest penalty.

Checking account: a deposit account upon which checks can be written to withdraw funds.

Churning: a stockbroker's encouragement of an investor to trade securities frequently so that the stockbroker can earn more income from commissions.

Closed-end: companies in which there is a set number of shares to be sold, and are outstanding. The shares are traded on the major exchanges.

Closing costs: fees payable immediately before you receive title to your home. These fees include costs associated with the attorney, preparing and filing the mortgage, taxes, title search, credit report, survey, insurance, etc.

Collateral: something of value pledged to assure repayment of a loan and subject to seizure if loan is not repaid.

Collateral trust bond: a bond that is secured by financial assets, such as notes receivable and accounts receivable.

Co-maker (or co-signer): an individual with a good credit rating who signs the note of another person to provide additional security for that person's loans.

Commercial paper: short-term, unsecured promissory notes (IOUs) issued by well-known and well-regulated business firms.

Commission: the broker's fee for handling a stock transaction.

Commodities market: this refers to a market in which there is active trading of 25 or so commodities, many of which are agriculture products such as corn, cotton, and soybeans. The commodity itself is not traded. What is traded are contracts for the future delivery of these products.

Common stocks: securities representing an ownership interest in a corporation, and carrying specified rights for the owner.

Competitive bid: an offer to buy Treasury securities in which the prospective purchaser states the rate of interest or yield that he or she is willing to accept.

Composite return: dividends plus expected appreciation.

Compounded interest: interest earned on interest already paid on the invested principal when it is left to accumulate with the principal.

Compounding: computing the new principal figure by using as a base both the previous principal and change accruing to that previous principal.

Confirmation statement: a statement sent to the investor describing the details of the trading transaction ordered by the investor.

Consumer-type certificate: a certificate of deposit with no federal minimum denomination issued by depository institutions for periods of from three months to five years.

Contingent monetary receipts: money or income that an individual may or may not receive, depending on future developments.

Corporate bond: a debt instrument or an IOU issued by a business corporation.

Coupon bond: a bond with interest coupons attached. Coupons are clipped as they come due and are presented by the holder to the paying agent for payment of interest.

Coupon interest rate: the interest rate specified on the bond certificate and on interest coupons attached to a bond.

Coupon yield: the interest rate specified on the securities (notes or bonds). This is also referred to as the coupon rate.

Credit: the promise to pay in the future in order to buy in the present.

Credit history: the record of how a person has borrowed and repaid debts.

Credit scoring history: a statistical system used to rate credit applicants according to various characteristics related to creditworthiness.

Creditor: one who lends money or permits another person to owe money to him or her.

Cumulative: a feature of a preferred stock indicating that, if dividends are not paid in full, the accumulations must be paid in the future before any dividends can be paid on the common stock. When stock is noncumulative, the corporation is not obligated to make up unpaid dividends.

Debenture: an unsecured, long-term certificate of debt issued by a company against its general credit rather than against a specific asset or mortgage.

Debit card: a plastic card, similar in appearance to a credit card, that customers may use to make purchases through a point of sale terminal. The machine readable card allow immediate withdrawal from the customer's checking or savings account with the money being transferred to the merchant's account.

Debt service: interest requirements plus stipulated payments of principal on outstanding debt.

Default: failure to perform a contract obligation, particularly the payment of principal or interest on a bond or note at a stated date.

Deferred annuity: an annuity in which the investor or buyer does not begin to receive income payments until a specified time period elapses.

Delinquent: a debtor who is behind in making payments on a debt and has made no satisfactory arrangement with the lender.

Depository institution: commercial banks, savings and loan associations, mutual savings banks, savings banks, and credit unions.

Direct deposit: a system in which the employee's or investor's earnings are deposited directly to his or her account at a depository institution.

Discount: a bond selling below par.

Discount a note: when the lender deducts the interest amount from the face value of the note and remits the remainder to the borrower.

Discount loan: a loan in which there is a deduction from principal for interest and finance charges at the time a loan is made.

Discount rate: the rate of interest that Federal Reserve Banks charge financial depository institutions that wish to borrow funds from these banks.

Discounted price: the actual dollar amount that the purchaser pays for a Treasury bill. The difference between this discounted price and the face value of the bills—assuming the bill is held to maturity—is called the discount.

Disposable income: take-home pay or net pay.

Diversification: spreading investments among different companies and institutions in different fields.

Dividend payment rates: the percentage of a company's total earnings paid out to stockholders as cash dividends.

Dividend rate: the annual rate of interest paid on passbook savings accounts.

Dividend yield: percentage earning on stocks that can be computed by simply dividing the annual dividend by the market price of the stock.

Dividends: earnings on the ownership of stock, both common and preferred.

Dow–Jones: better known as the Dow–Jones Industrial average; number indicators of the movements of prices of certain groups of thirty stocks (utilities, indust

Durable goods: manufactured products capable of long use, such as refrigerators, automobiles, and various household appliances.

Early withdrawal penalty: a fee that the depositor must pay in order to withdraw funds from the certificate of deposit before its maturity.

Equities: common or preferred stock in a corporation.

Estate: a person's ownership and/or interest in all forms of property. Also, the financial resources and personal assets left upon the person's death.

Eurodollar: deposits denominated in U.S. dollars at banks and other financial institutions outside the United States.

Executor (executrix): an individual appointed in a will and approved by a probate court to administer the disposition of an estate according to directions in the will.

Face value: the value of a bond that appears on the face of the bond, ordinarily the amount the issuing company promises to pay at maturity. It is not an indication of market value. For insurance, face value is the dollar value that expresses coverage limits. It appears on the front of the policy.

Family of funds: a number of mutual funds managed by the same investment company, with each fund specializing in a different kind of security or investment product.

Finance charge: the cost of a loan in dollars and cents as defined by the Truth in Lending Act. The interest charged is just one component of the finance charge.

Financial instrument: any written document or contract having monetary value or showing a monetary transaction.

First mortgage: a legal instrument that gives a creditor a claim against an owner's right in real property prior to a claim of all other creditors.

Fixed expenses: expenses such as monthly rent or mortgage payments that must be paid at regular intervals, in set amounts, and do not vary with activity.

Fixed rate certificate of deposit: a certificate of deposit on which the annual interest rate is contractually fixed until maturity.

Float: checkbook money that for a period of time appears on the books of both the

check writer and the check receiver due to the normal lag in the check collection process.

Foreclose: when a creditor sells property in the possession of the debtor with a view toward applying the proceeds to the liquidation or reduction of the debt.

Garnishee: a legal action taken by a creditor to secure payment of a debt by attaching the debtor's salary or other income.

General obligation bonds: government bonds secured by the full faith, credit, and taxing power of the issuing unit.

"Ginnie Maes": a name given to certificates issued by the Government National Mortgage National Association, a federally-chartered corporation.

Governments: a term given to all securities issued by the U. S. Treasury.

Grace period: the period between the date an item is charged on credit or a billing is received, and the date that interest charges begin.

Growth: appreciation or increase in value.

Hedge: protection against a potential investment loss by making a counter balancing transaction.

Home equity: the difference between the fair market value of your home and any outstanding mortgage balances.

Impulse buying: unplanned buying or buying on a sudden decision.

Income maintenance programs: government programs that provide financial assistance to people who need a supplement to their income.

Income stock fund: a mutual fund in which the portfolio consist mostly of stocks noted for producing generous dividends.

Indenture: a legally written agreement between bondholders and the debtor as to the terms of the debt.

Inflation: a period of persistent rises in the general price level.

Installment loans: a loan repaid in two or more payments made at regular intervals over a period of time.

Institutional investors: a purchaser or seller of securities who acts on behalf of an institution, such as a pension fund, trust fund, mutual fund, or insurance company.

Interest rate: the price in percentage form paid for credit on the privilege of borrowing money.

Inventory: a completed listing of all the household's assets.

Investment club: an organization of individuals who want to share their investment knowledge and contribute a limited amount of funds for investing.

Investment trusts: any firm that takes its capital and invests it in other companies.

Joint tenancy with right of survivorship account: an account owned by two or more persons arranged so that if one joint tenant dies, the surviving tenants continue to have the same rights to the account as they had previously.

Junk bonds: these are "high yield," low grade bonds that are rated as speculative by the major rating agencies, and are therefore considered more risky than high-or investment-grade bonds.

Leveraging: borrowing money to invest in assets such as stocks, bonds, or real estate.

Liquid assets: all real and personal property owned by a person or household that can easily be converted into cash at a readily determinable fair price.

Liquidity: the ease with which an asset can be converted into cash with little risk of loss of principal.

Loan provision: a clause in the policy that explains how the policyholder can borrow up to the total accumulated cash value of the policy.

Logo: a symbol used by a particular firm or agency for identification purposes.

Long-term capital gain: a gain made on the buying and selling of a capital asset held for more than one year.

Low-grade high-yield bonds: bonds issued by corporations who are able to obtain from the major rating agencies ratings that would attract most investors.

Margin call: a demand from a broker to repay part of a loan used to help purchase stock—if the value of the stock falls below a certain percentage of the outstanding loan amount.

Margin on mortgage loans: the number of percentage points the lender adds to the index rate to determine the interest rate to be charged.

Margin rate: the proportion of the total purchase price of securities that must be paid in cash.

Marginal tax rate: the tax rate applicable to the highest portion of one's taxable income.

Market-makers: brokers who are willing to buy back a security from a customer at a certain price.

Market rate: average rate of interest set by the major suppliers and users of credit.

Maturity: the date when the debt is due.

Maturity yield: the rate of return expressed in a percentage that will be obtained on an investment if the investment is held to maturity.

Minimum denomination: smallest amount you can buy.

Money market assets: investments in financial instruments such as bank certificates of deposit and short-term Treasury securities.

Money market CD: a certificate of deposit purchased from a depository institution. The minimum denomination is \$2,500 and the maturity or term is 26 weeks.

Money market investments: investments that yield the market rate of interest as money market deposits accounts and money market mutual funds.

Mortgage bond: a bond secured by real estate.

Municipal bonds: interest-bearing obligations of a state or any political subdivision of a state, such as a town, county, or city.

Mutual funds: registered investment companies whose securities are offered to the public and whose assets are invested in a number of different securities in which the shareholders have, in effect, an undivided interest.

Net equity: total market value of the securities in the investor's account less any outstanding loans or fee charges on the account.

Net worth: the difference between the assets and debts (liabilities) of a person or household.

New worth statement: a financial form that lists, as of a specific date, the financial assets and liabilities of a person or household, and shows the difference between the two as the net worth.

No-load fund: a mutual fund that does not have a sales charge.

Noncompetitive bid: an offer to buy Treasury securities, in which the prospective purchaser does not state the rate of interest or yield that he or she is willing to accept.

NOW (Negotiable Order of Withdrawal): an interest bearing account on which checks may be drawn.

Odd-lot: a block of stock of more or less than one hundred shares as a trading unit.

One-signature account: an account owned by two or more persons arranged so that either joint owner is authorized to conduct transactions.

Open-end: companies in which new shares of the fund are sold whenever there is a request.

Opportunity cost: the benefit foregone (or opportunity lost) by using an asset in a particular venture other than its best alternative use.

Optimum value: not always the highest rate of return, but a respectable rate of return, in view of other desirable characteristics, such as safety, liquidity, and minimum tax liability.

Option: the right to buy or sell something at a specified price within a specified period of time.

Optional negotiability: the choice of letting the owner of the certificate transfer it to another person through the proper endorsement.

Overdraft: a check written by a depositor for more money than the depositor has in his or her account.

Overdraft checking: a checking account associated with a line of credit that allows a person to write checks for more than the actual balance in the account, with a finance charge on the overdraft.

Overdrawing an account: writing a check for more than the balance on deposit in the account.

Par value: the face value printed on common and preferred stocks and bonds. As this is meaningless for common stock, most of it is issued as no-par stock of \$1 par.

Passbook savings account: a savings account in which the saver has a book to record all transactions, such as deposits, withdrawals, and interest earnings.

Passive activity: any activity that involves the conduct of any trade or business, and in which the taxpayer does not materially participate. Any rental activity is considered a passive activity even if the taxpayer does materially participate in the activity.

PIE ratio: this is price earnings ratio and is expressed as a multiple of the price of a share of stock to the company's earnings per share.

Petition: a written request to a court or a judge asking the granting of some remedy or relief.

Point of Sale (POS): Point of Sale systems allow for transfer of funds between accounts, authorization for credit, verification of checks and provision of related services at the time of purchase. POS terminals are located in some shopping areas and allow customers of participating financial institutions to effect transactions through the use of machine-readable debit cards.

Points: some extra percent of the amount borrowed, included as part of the loan fee. Finance charges paid at the beginning of a first mortgage in addition to monthly interest; each point equals one percent of the amount financed.

Portfolio: the aggregate of investment held by an individual or organization.

Preferred stock: corporate ownership that features a fixed dollar income, and if the corporation has any earnings, this form of ownership has a claim on earnings and assets before the claim of common stock.

Premium: the single or periodic payment on an annuity contract; also on other types of insurance policies.

Premium bonds: bonds selling above par.

Prime rate: interest rate charged by commercial banks to their most credit worthy customers. It is a minimum rate and it takes into account the customer's deposit balance and financial strength.

Principal: the investor's payments, less expenses.

Proceeds of the policy: the total amount of the insurance policy realized or to be received by the beneficiary when the policy is paid off.

Project bonds: municipal obligations, with maturities longer than one year, backed by the federal government.

Project notes: municipal obligations, with one-year maturities, backed by the federal government.

Prospectus: a document issued by a company and filed with the Securities and Exchange Commission to describe the securities to be offered for sale and under what conditions they will be offered, as well as the prospects for company performance.

Rate: a percentage of the principal and is the fixed interest that the issuer or borrower promises to pay you for using your money.

Rating organizations: firms that operate investment advisory services. The firms evaluate the relative worth of particular securities.

Real income: an individual's income in dollars adjusted for a change in the price level.

Redeem: to buy back.

Regional exchanges: any organized securities exchange outside New York City.

Registered bond: a bond in which the owner's name is registered with the paying agent. The paying agent is a commercial bank that distributes the interest payments and repayment of principal.

Remaining liquid: having assets in cash or in a form that can be converted to cash immediately and easily.

Repurchase agreements: an agreement by a bank or the Federal Reserve to buy back, under certain terms, securities which it originally sold to a second party.

Returned check: a check submitted by a depositor to his or her bank for payment but returned unpaid for one reason or another.

Revenue bond: bonds for which the interest and return of principal are payable from and secured by stated and expected revenues from a specific project or group of projects.

Round lot: the general unit of trading in a security, such as 100 shares.

Savings instrument: any contractual agreement with a financial institution in which the saver is assured of interest earnings on his or her funds.

SEC: the Securities Exchange Commission, Federal agency responsible for regulating the securities market and all publicly held investment companies.

Second mortgage: a loan specifically secured by an individual's equity in real property, which is subordinated to the equity interests of any first mortgage holder.

Secondary market: a market for buying and selling previously issued securities.

Secured bond: a bond secured by tangible assets.

Short-selling: a technique in which an investor borrows stock from a broker in the hope of selling it on the market when the price is high, then buying it back when the price has dropped, and returning it to the broker after having made a profit.

Short-term: a period of one year or less.

Signature loan: a loan granted on the basis of a borrower's creditworthiness and signature; not secured by collateral.

Simple interest: a method of calculating interest on the outstanding balance that produces a declining finance charge with each payment of the installment loan.

Single-premium annuity: a one-time or lump sum payment by an investor in the purchase of an annuity.

Sinking fund: a reserve of cash annually set aside from corporate earnings to ensure that there will be enough money to redeem bonds at maturity.

Speculative venture: an investment made despite great uncertainty in the hope of making a profit or achieving a substantial gain.

Split rate: an interest rate structure that pays regular NOW account rate on the first \$2,500 and a much higher rate on the account balance above \$2,500.

Statute of limitations: a statute which bars suits upon valid claims after the expiration of a specified period of time.

Statutes: laws established by the act of a legislature.

Stock certificates: evidence of ownership of stock in the form of a certificate, which shows among things, the number of shares owned, the issuing corporation, whether the stock is at par value and rights of the stockholder.

Stop payment: a request by a depositor to his or her bank to refuse payment on a check written by the depositor.

Sweep: an operation in which a depository institution periodically removes funds from one account of a depositor and places such funds into a higher-yielding account for the depositor.

Take-over: an attempt to buy the controlling interest in a firm by another investor group.

Tax avoidance: the use of legal means to minimize one's taxes.

Tax liability: the amount of income taxes owed by an individual.

T-bills: short-term U. S. Treasury securities issued in minimum denominations of \$10,000 and usually having initial maturities of 3, 6, or 12 months.

Tender: a form used to purchase Treasury bills.

Term: the length of time for which the principal is borrowed.

"Thriffs": a general term for savings and loan associations, credit unions, mutual savings banks, and savings banks.

Time deposits: funds that are deposited under agreement for a stipulated period of time.

Title: evidence that a person is the legal owner of property.

Transactions accounts: any account on which checks are written regularly to pay bills.

Transfer agent: a firm: typically a bank, that is authorized by a corporation to administer and record the transfer of its stocks or bonds between investors.

Treasury notes: intermediate-term coupon-bearing U. S. Treasury securities having initial maturities of from two to ten years and issued in denominations of \$1,000 or more.

Treasury securities: interest-bearing obligations of the U. S. government issued by the Treasury Department. These obligations fall into three categories—bills, notes, and bonds.

Variable annuity: an annuity contract providing lifetime retirement payments that vary in amount with the results of investment in a separate account portfolio.

Variable interest rate: an interest rate that changes periodically in relation to an index. This means that the interest payments may increase or decrease accordingly.

Variable rate certificate: a savings certificate on which the rate of interest payable changes, depending on the term for which the money is pledged.

Vendors: companies that sell.

Volatility: a measure of rapidity with which security changes in value as compared to the market generally.

Yield (or rate of return): measurement of the profitability of an investment; it is usually per year on the amount invested; often referred to as return of investment.

Yield to maturity (YTM): the total of the coupon or annual rate of return on the bond and any difference in the price paid for the bond and its face value.

Zero coupon bond: a bond that pays no interest. It is sold at a deep discount at the time of issuance, and thus the buyer's gain is the difference between the discount price and the face value of the bond collected at maturity.

Source notes

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